Globalisation and global crises

Assaf Razin 23 April 2021

Concerns associated with the Covid-19 pandemic have led to new rationales of protectionism, with renewed emphasis on domestic production and sourcing. This column compares the current economic crisis brought on by the pandemic to previous major economic crises and examines what this could mean for the future of various aspects of globalisation.

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In his 1919 book, *The Economic Consequences of the Peace,* John Maynard Keynes described the open borders of the then bygone first age of globalisation before WWI:

> "*The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery on his doorstep, he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, [and] he could secure forthwith, if he wished it, cheap and comfortable means of transit to any country or climate without passport or other formality*."

Globalisation did reverse its course in the second period, from the outbreak of the WWI in 1914 until the end of WWII in 1945. WWI led to prolonged economic dislocation, which included the withdrawal of Russia from world trade after the communist revolution in 1917, the Spanish flu pandemic in 1918-1919, monetary instability in the early 1920s, new immigration restrictions, the Great Depression starting in 1929, and a severe outbreak of protectionism in the 1930s. Today, health concerns are providing new rationales for protectionism, especially for international travel, medical gear, food, as well as a renewed emphasis on domestic sourcing.

A look at the history

In surveying past crises, Reinhart and Rogoff (2014) discovered startling qualitative and quantitative parallels across a number of standard financial crisis indicators in 18 post-war banking crises. They found that banking crises were protracted (output declining for two years, on average); asset prices fell steeply, with housing plunging, and equity prices declining by 55% over 3.5 years. Unemployment rose by seven percentage points over four years, while output fell by 9%.

Figure 1 Global growth, 1871-2020

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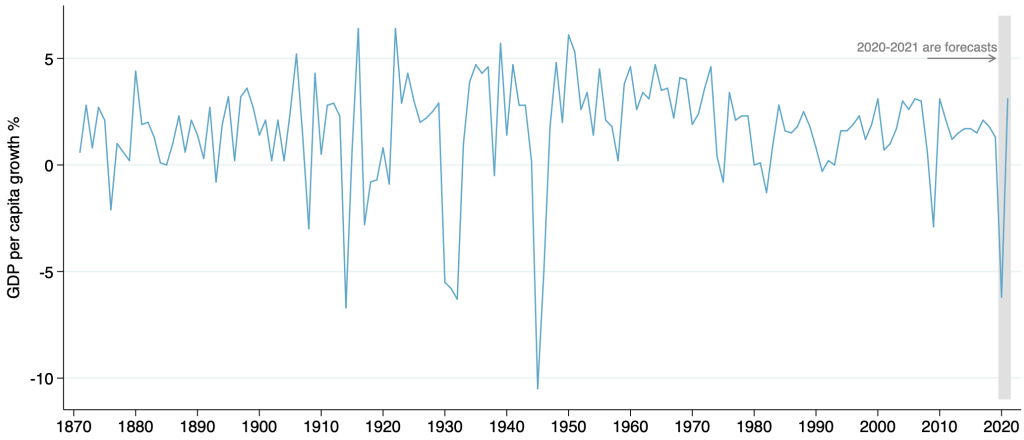
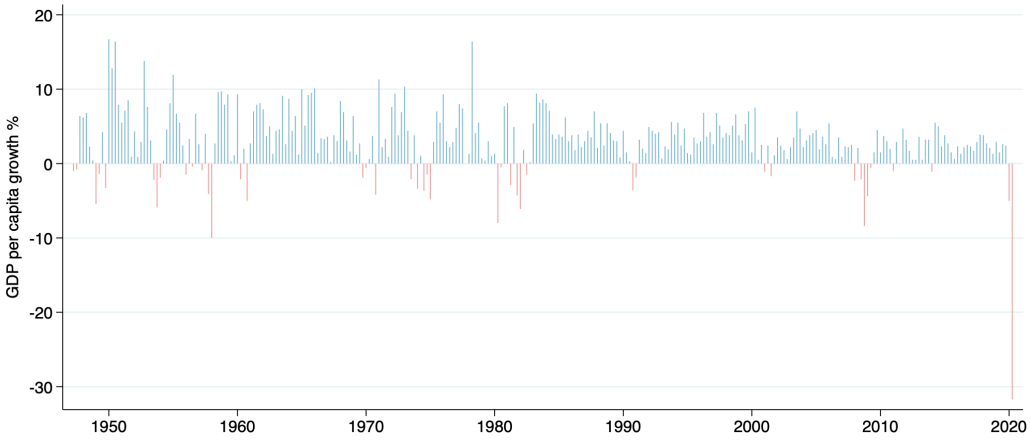


Source: World Bank (2020), *Global Economic Prospects*.

Since 1870, the global economy has experienced 14 global recessions. Current projections imply that the Covid-19 global recession will be the fourth deepest in this period and the most severe since the end of WWII.

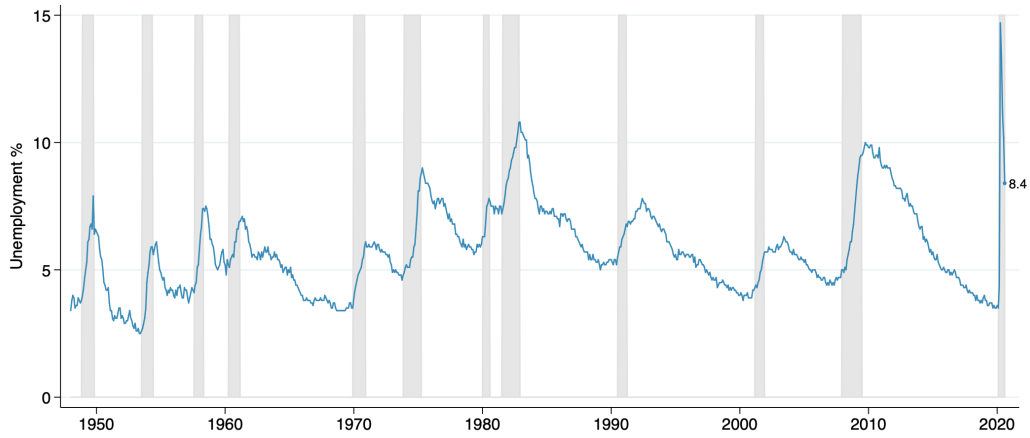
Figure 2 US GDP: Percentage change from previous quarter, 1950-2020Q2



Source: US Bureau of Economic Analysis (2020).

Lockdowns brought US unemployment rates to a historical high (see Figure 3). Exiting from the lockdown, US jobs grew by 4.8 million in June 2020. It was the second month of a strong job gain (after lockdown led to huge losses, when businesses laid off or furloughed[1] tens of millions of workers as the pandemic put a large swath of economic activity on ice). The employment rebound came partly thanks to over $500 billion in federal aid offered to small businesses on the condition that they retain their workers (the one-off 'Paycheck Protection Program').

Figure 3 US unemployment rate since 1948



ureau of Labor Statistics and the Federal Reserve Economic Data.
employment rates are seasonally adjusted.

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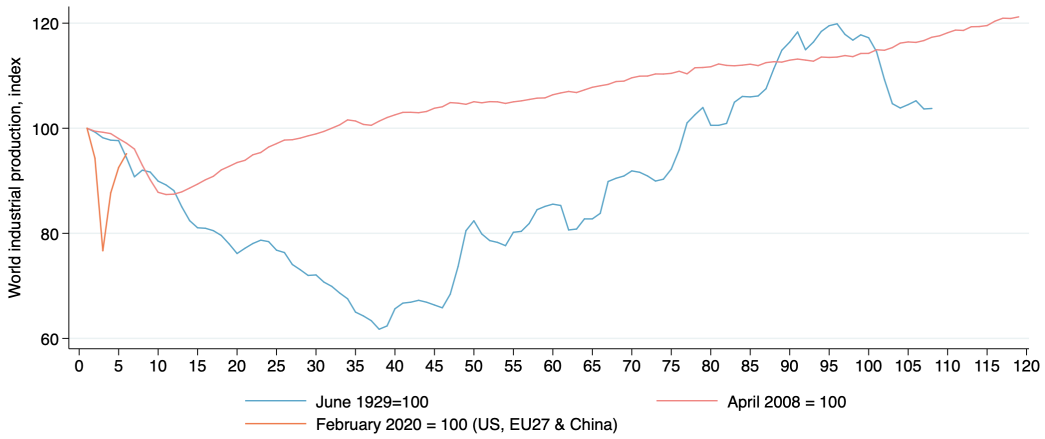
Figure 4 shows the index of world industrial production during the months following the onset of two crises: June 1929 for the Great Depression, and April 2008 for the Global Crisis. It tracks pathways in the initial phases of several global crises.

Figure 4 World industrial production: Great Depression versus Global Financial Crisis



Sources: (i) Eichengreen and O'Rourke (2010), updated dataset. (ii) Recent data for US and EU are taken from the OECD (Organisation for Economic Co-operation and Development) (2020). (iii) The Chinese data are taken from the National Bureau of Statistics of China (Press release, August 2020).
Note: Indices are weighted by 2019 real GDP in ppp (purchasing power parity) from the OECD.

Eichengreen and O'Rourke (2010) observe that the downturns following the two financial crises were initially very similar. The difference in the two occurred after about ten months. During the Global Crisis there was a relatively quick recovery after ten months. Such a recovery did not occur during the Great Depression of the 1930s. The downturn continued for another 25 months before a steadier recovery then set in.[2]

The first year of the 2008-2009 slump in industrial production and trade was fully comparable to the first year of the Great Depression from 1929 to 1933. The Global Crisis has some similarities with the Great Depression. It appears that in both cases the trigger is a credit crunch following a sudden burst of asset-price and credit bubbles. But differences in financial institutions and policy reactions may explain the divergence of tracks after the initial stages. Recovery of world industrial production started much earlier in the Global Crisis than in the Great Depression. Periods of depressed output are significantly shorter in the former than the latter (on account of different policy reactions and improved financial and budget institutions).

This does not amount to a claim that economists understand how to employ fiscal policy and supplementary monetary instruments to optimally recover from or prevent future re-occurrences – given the often-destabilising expectations of the private sector, due to conflicting incentives, finance fragility, and politically gridlocked governments. It means that complacency based on incomplete knowledge of how the system works is no longer tenable, and a reassessment of past output, employment, and financial stabilising measures is in order.

In comparing the Global Crisis to the 2020 Covid-19 crisis, there are few key differences. First, in terms of origin, the shock that triggered the Global Crisis was internal to the economy. The crisis originated from the malfunctioning of the economy's financial system. In contrast, the shock that started and prolonged the Covid-19 crisis was external to the economy. The crisis is driven by epidemiology forces.

Second, in terms of the magnitude of the initial shock, quantitatively the first quarter's decline since the beginning of the crisis – in terms of employment and output – is greater in the Covid-19 crisis case, compared with the Global Crisis.

Third, in terms of length of recovery, the recovery period from the Covid-19 crisis is expected to be short, once vaccines are rolled out and large segments of the population are covered. In contrast, the recovery period in the Global Crisis case was protracted.

Theoretical aspects

Guerrieri et al. (2020) demonstrate that, in a general equilibrium setting, supply shocks such as Covid-19 can trigger changes in aggregate demand larger than the shocks themselves. This is
e when supply shocks are concentrated in certain sectors – as they are during a shutdown in
e to a pandemic. The fact that some goods are no longer available makes it less attractive

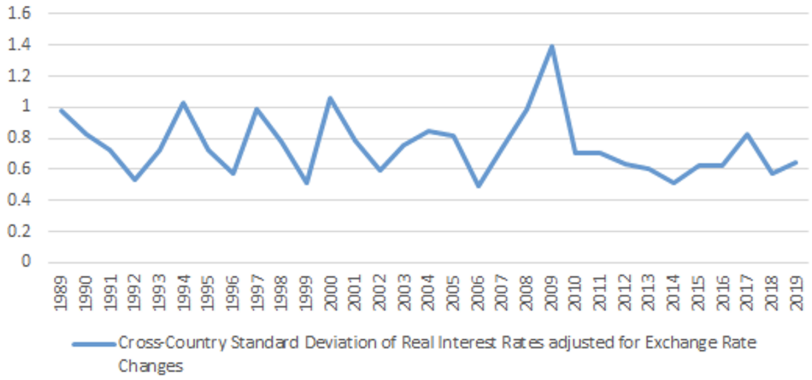
to spend overall. An interpretation is that lockdowns increase the 'shadow' price of goods in the affected sectors, making total current consumption effectively more expensive, discouraging it as a result. On the other hand, the unavailability of goods in some sectors can shift spending towards the other, less affected sectors through a substitution channel. Whether or not full employment is maintained in the sectors not directly affected by the lockdown measures depends on the relative strength of these two effects. A supply shock in one sector can spill over into a demand shortage in another sector, which is amplified by incomplete markets.

Further, Guerrieri et al. (2020) show that in a situation where consumers are credit-constrained, contraction in employment in unaffected sectors becomes more likely. Intuitively, if workers in the affected sectors lose their jobs and income, their consumption drops significantly if they are credit-constrained. If workers in the unaffected sectors increase their consumption of the remaining goods sufficiently, aggregate demand will not contract. But this requires a higher degree of substitution across sectors. If goods are not very close substitutes, aggregate demand contracts more than supply, and employment in the unaffected sectors falls.

Financial globalisation

Full international financial integration requires that, in the long run (when prices adjust to various shocks and markets clear), there is arbitrage of the real exchange rate-adjusted rate of return.

Figure 5 Cross-country standard deviation[3] of real interest rates, adjusted for exchange rate changes



Source: Stats Bureau, Federal Reserve Economic Data (FRED), World Bank.

Note: Real-exchange-rate adjusted yields on three-month government bonds for Israel, Canada, Germany and the United Kingdom, and the yields on three-month US government bonds.

Figure 5 provides strong evidence for financial integration among advanced economies. The figures show that the dispersion among countries in terms of the real interest rate adjusted by real exchange rate changes is narrowing over time.

Trade globalisation in retreat

Trade creates more complex global inflation dynamics. The ICT (information and communications technology) revolution has made a significant unbundling of production chains possible – large wage differentials across countries have made doing so profitable. This has generated vast new quantities of 'supply chain trade'. Greater international economic interconnectedness over recent decades has been changing inflation dynamics (Carney 2017). The expansion of global value chains – that is, cross-border trade in intermediate goods and services – is an important channel through which global economic slack influences domestic inflation.[4] Auer et al. (2017) argue that as global value chains expand, direct and indirect competition among economies increases, making domestic inflation more sensitive to the global output gap. This can affect the trade-offs that central banks face when managing inflation. The 'slope' of the Phillips curve[5] may have changed (Razin 2018). There is evidence that global inflationary cycles that correspond with intensifying globalisation propagate common shocks via commodity, trade, and financial channels. Correlations of consumer price inflation are as elevated today as during the first oil shock. On the surface we appear to be in the midst of a highly synchronised global rates cycle.

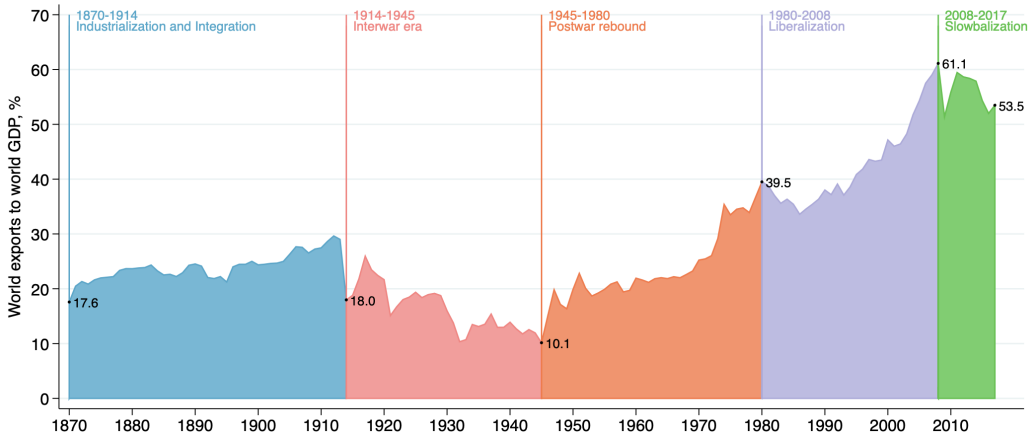
A measure of financial integration is how close a country's real interest rate (adjusted for real exchange rate evolution into the next period) is to that of countries using different currencies and different domestic price adjustments processes in the long run when domestic price adjustments to takes place.

Global value chains will likely undergo a drastic transformation in the decade ahead. The change will be driven by a push for greater supply chain resilience due to the pandemic.

One aspect of a lack of resilience of the last decades of globalisation is that GVCs were not sufficiently diversified and hence, highly vulnerable to shocks such as the pandemic or trade conflicts. Even prior to the Covid-19 pandemic, trade globalisation was challenged by a rising wave of populism spurred by economic discontent in Europe, the US, Latin America, and elsewhere, as well as the trade war between the US and China. The global value chains could now be reshuffled or reduced. Whether they will be localised or regionalised, or whether the crisis will lead to the continuation of globalisation, remains to be seen. A short period of economic recession seems unavoidable, but the question is whether Covid-19 crisis will transform globalisation structurally in the long term.

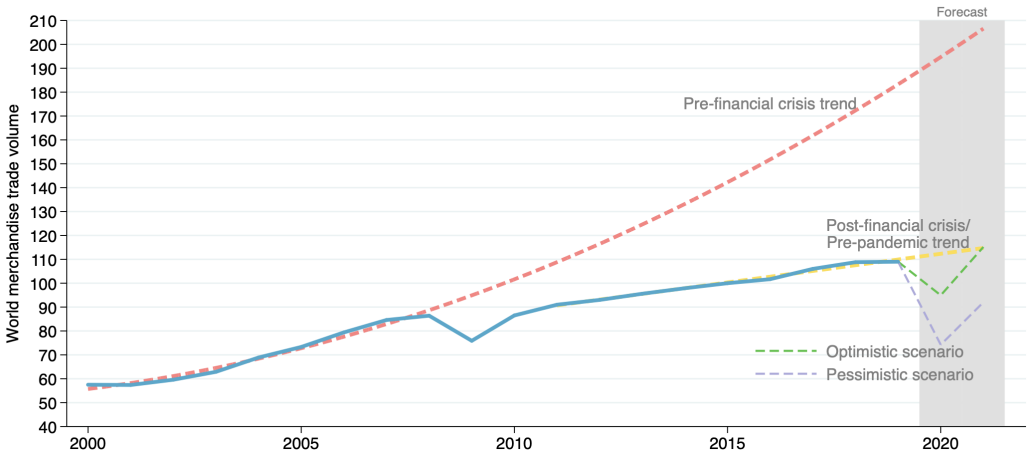
Global trade – as measured by the ratio of world exports to world GDP – is a proxy for economic integration. Figure 6 indicates five periods of modern globalisation. The pandemic is expected to add further momentum to the de-globalisation trend. The forecasted diminished world trade in goods is shown in Figure 7.

Figure 6 Ratio of world exports to world GDP, 1870-2007



Source: Our World in Data, “Globalization over 5 centuries, World”.

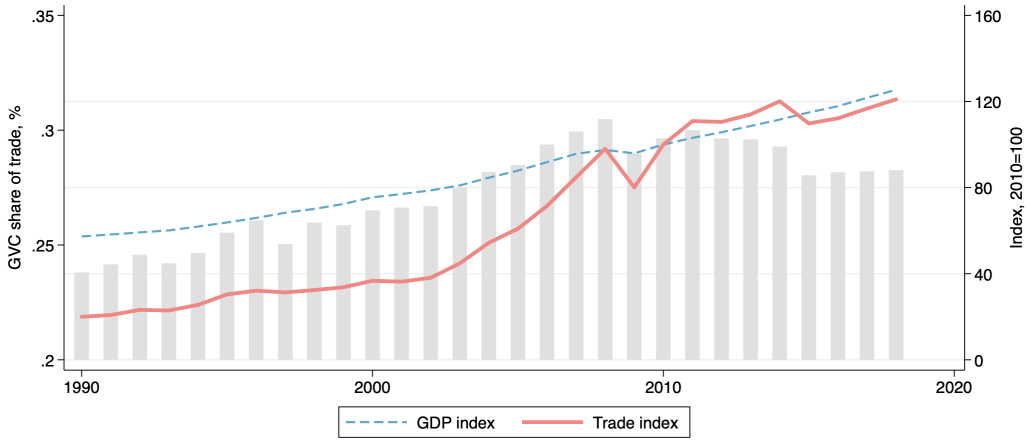
Figure 7 Volume of world merchandise trade



Source: World Trade Organization, Merchandise export volume indices.

The United Nations Conference on Trade and Development (UNCTAD) World Investment Report has monitored foreign direct investment (FDI) and the activities of multinational enterprises for 30 years, a period in which international production saw two decades of rapid growth followed by a decade of stagnation. Flows of cross-border investment in physical productive assets stopped growing in the 2010s, while the growth of trade slowed down and global value chain trade also declined (Figure 8).

Figure 8 Global value chain trade



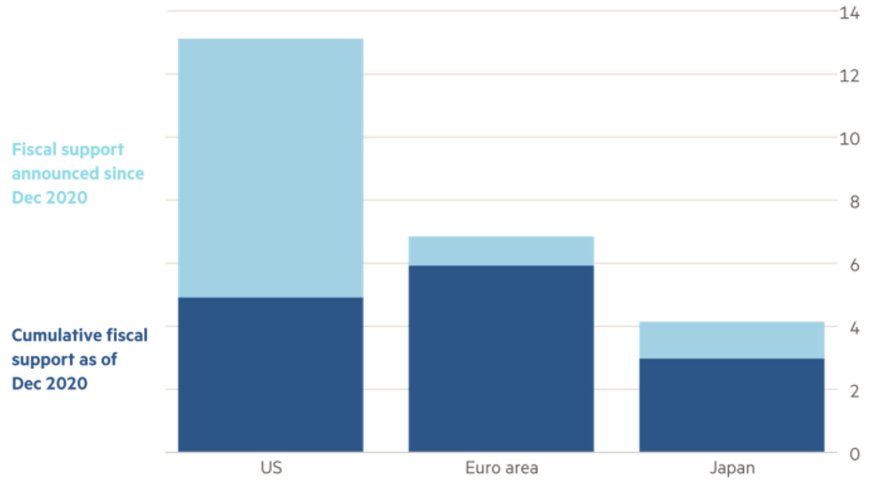
Sources: The Eora Global Supply Chain Database, UNCTAD (2020), and the World Bank (2020).
Note: (i) Trade is global exports of goods and services. (ii) GVC share of trade is proxied by the share of foreign value added in exports, based on the UNCTAD-Eora GVC database (Casella et al. 2019).

Conclusion

The pandemic-induced slump in economic activity is deep. Consumer spending, investment, and export demand have tumbled. And central banks tied down by zero interest rates are losing their most effective stabilisation policy instrument. Consequently, the burden falls on fiscal policy. When Covid-19 hit, supply chains and production were disrupted. But the bigger impact of the pandemic has been on the demand side – the desire to invest has plunged, while people across the richer parts of the world are now saving much of their income.

As the Covid-19 crisis hit advanced economies at the time that the central banks' policy rate was at the lower bound, this rendered monetary policy weakened as a stimulus tools to assist the recovery. The pandemic shock also has been uneven in its effects on various income groups, and monetary policy is not designed to deal with these income gaps. As a result, fiscal policy has been the only way to deal with the recession and the relief to some segments of the society which was called for. The US has been outstanding in this respect.

Figure 9 Fiscal Support in the US, EU, and Japan as a percentage of GDP



Source: OECD Data Base.

Figure 9 demonstrates the big relief packages among the major groups of developed economies. Note that in the US federal system, the fiscal union makes a significant difference in contrast to the EU with its uncoordinated national fiscal policies. This reflects the greater risk-sharing embedded in a fiscal union of the scale of the US and a combination of greater macroeconomic coordination of national fiscal policies.[6]

In the longer term, there is a risk that younger students from poorer backgrounds will struggle to catch up after an extensive period of being out of school due to lockdowns and other disruptions. As education disruptions caused by the pandemic distort the development trajectory of children, social

could decline, further lowering productivity and raising inequality.

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Endnotes

1 Furlough is an involuntary, temporary leave of absence with workers being able to retain their jobs at the end of the period of leave.

2 See also De-Grauwe and Ji (2020).

3 Standard deviation is a measure that is used to quantify the amount of variation or dispersion of a set of values from the average of that set.

4 See Baldwin and Freeman (2020).

5 The Phillips curve represents the relationship between inflation and unemployment rates in an economy. The two variables are expected to have an inverse relationship. The slope of the curve indicates the responsiveness of inflation to unemployment.

6 See Razin (2021: Chapter 6).

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