

SPEECH

Globalisation after the pandemic

2021 Per Jacobsson Lecture by Christine Lagarde, President of the ECB, at the IMF Annual Meetings

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It is a pleasure to be back in Washington and to deliver this year's Per Jacobsson Lecture.

As a young man in the 1920s, Jacobsson worked in the Economic and Financial Section of the League of Nations Secretariat. There, he was actively involved in work on Europe's financial reconstruction in the wake of the greatest shock that had hit the continent: the First World War.

The outbreak of that conflict in 1914, which killed so many and injured even more, marked the end of the first era of globalisation. The unprecedented flows of trade that had characterised the global economy between the 1870s and the early 1900s collapsed, as borders were replaced by battlelines.

The pre-war world quickly became, as the writer Stefan Zweig put it, "the world of yesterday". This shows how fast what had once seemed so permanent can change. Globalisation will always be vulnerable to global shocks, as we have recently seen with the pandemic.

But the pre-pandemic world has not joined the world of yesterday just yet. A powerful economic logic drove the most recent era of globalisation, and that logic remains just as valid today.

However, we are seeing this logic challenged in important ways. Protectionism is rising, climate change is accelerating and industrial policy is shifting. Economies that have embraced globalisation, like Europe, are more exposed to these changes.

Europe has reaped the benefits of globalisation in the past and has suffered enormously from its fall-back. To reap the benefits in the future in a globalised world in transition, Europe must adapt.

That means using Europe's economic weight to support reciprocated trade openness globally, while strengthening its own domestic demand to insure against a more volatile global economy.

A stronger Europe would be a global public good, providing an anchor of stability in a less predictable world. And it has the scale to prepare this journey. Will it have the will?

Europe in a globalised world

In the decades before the pandemic, rapid globalisation profoundly transformed international trade for the better. Between 1995 and 2010, the pace of world trade growth expanded twice as fast as that of world GDP growth.^[1] And the nature of trade was transformed by the expansion of global value chains, a web of interlinkages that developed as production unbundled across borders.

This integration was driven by technological progress in the private sector^[2], but it was also enabled by public policy. Governments across advanced economies pushed for trade barriers to be lowered and the World Trade Organization to be expanded to include emerging economies. Globalising trade was seen as desirable for two main theoretical reasons:

The first was the classical argument, going back to David Ricardo, about the mutual gains from trade.^[3] Lowering barriers would allow countries to exploit their comparative advantages. Countries would also benefit from lower import prices, technology spillovers and productivity gains from the international division of labour.

The second reason was to exploit diverse sources of demand as a means of diversifying risk in the face of domestic shocks. Deeper trade integration would allow countries to “rotate” demand to growing external economies when they experienced domestic slowdowns. As a result, business cycle volatility could be partially decoupled from its adverse effects on long-term growth.^[4]

Both these arguments were broadly borne out.

Globalisation did increase growth: across all economies, a one-point increase in measures of globalisation was associated with an increase in the five-year growth rate by 0.3 percentage points.^[5]

Hundreds of millions of people were lifted out of poverty in emerging markets. And Europe benefited, too. Between 2000 and 2017, jobs supported by exports to the rest of the world increased by two-thirds, to 36 million.^[6]

Trade integration also allowed countries’ growth to become less beholden to swings in domestic conditions.^[7] This proved especially valuable for Europe in the wake of the sovereign debt crisis. The ability to rotate demand from the domestic economy to the rest of the world provided a crucial outlet for producers. Between 2010 and 2014, external demand as a share of euro area GDP more than doubled.

But the flipside of greater trade openness is greater exposure to global shocks and, if the correct policies are not in place, the potential for people to turn against globalisation. For example, international trade can have implications for income inequality in advanced economies, which in turn can spur protectionism if not tackled effectively through distributional policies.^[8]

Between 1999 and 2019, trade as a share of GDP rose from 31% to 54% in the euro area, whereas in the United States it rose from 23% to 26%. But while Europe’s social model meant that protectionist pressures remained minor, we began to see a new shift towards protectionism in other major economies in the late 2010s.

Still, our deep integration into the global economy meant that we in Europe were particularly exposed to these changes – and our scope to benefit from open trade and diverse demand was arguably reduced.

Europe’s largest gains from trade had taken place against the backdrop of a particular geopolitical constellation, marked by the global dominance of the United States after the end of the Cold War and a multilateral commitment to governance by rules. But the re-emergence of protectionism began to call that global economic order into question.

In parallel, waning trade growth reduced the scope for countries to rotate demand to external economies when they needed to. After 2008, the pace of globalisation slowed and world trade growth no longer outstripped world GDP growth. In fact, by 2019 world trade growth had more than halved since the year before. This contributed to a manufacturing recession in the euro area on the eve of the pandemic.

For all these reasons, I was already highlighting back in 2019 the need for Europe to acknowledge that the world around us was changing fast, and to reconsider whether its growth model was sufficiently balanced in light of these changes.^[9]

A globalised world in transition

The pandemic has so far only reinforced this message. Though it is still too early to draw firm conclusions, the pre-crisis trends that capped the gains from both trade and diversifying demand could be becoming stronger.

First, the trend towards protectionism shows no signs of abating. In 2020, more than 1,900 new restrictive trade measures were implemented worldwide. That is 600 measures more than the average

of the previous two years.^[10] And there is evidence of further discriminatory practices being introduced this year.^[11]

This could cloud the outlook for future growth in world trade, especially if it elicits tit-for-tat responses. ECB analysis shows that, in a hypothetical case in which one major economy raises tariffs and non-tariff barriers by 10% and other countries respond in kind, world trade would be almost 3% lower than its baseline and global GDP would be almost 1% lower.^[12]

Moreover, new trade barriers not only harm euro area exports but the nature of these barriers is creating new vulnerabilities for Europe. Behind some protectionist measures is a shift in industrial policy, mainly led by China and the United States, towards security over efficiency in supply chains. This could create geopolitical biases in global supply chains in the future, especially for goods considered strategically important.

Such shifts would raise hard questions for industries where Europe is dependent on a limited number of global suppliers. For example, 45% of Europe's imports of active pharmaceutical ingredients are sourced from China, as is 98% of our supply of rare earth metals.^[13]

Second, there are signs that the global economy could increasingly be a source of shocks for Europe rather than a stabiliser against volatility.

We are already seeing that the just-in-time supply chains which have defined this era of globalisation are highly vulnerable to systemic shocks. And the efficiency of those supply chains multiplies the consequences of disruptions. The World Bank estimates that, for many goods traded in global value chains, a delay by one day is equal to putting in place a tariff of over 1%.^[14]

This naturally affects the euro area more than other economies by virtue of our exposure to globalisation. For example, ECB analysis finds that exports of euro area goods would have been almost 7% higher in the first half of this year were it not for pandemic-induced supply bottlenecks. For the rest of the world, the figure is only 2.3%.^[15]

Looking ahead, imported volatility might increase rather than decrease. Even after the disruptions created by the pandemic are resolved, we will have to contend with the consequences of a changing climate and changing industrial structures.

As the world heats up and climatic conditions become more extreme, we will face increasingly frequent ecological shocks. And we know from past experience that these shocks can have profound effects on supply chains.

For example, after the Tōhoku earthquake in Japan in 2011, US affiliates of Japanese multinationals saw their output fall at roughly the same rate as the declines in imported inputs from Japan.^[16]

Likewise, the 2013 drought in New Zealand – which produces around half of the world's powdered milk – caused a significant spike in world milk prices, with EU prices jumping by around a fifth between May and October of that year.

Even the necessary response to climate change – the acceleration of the green transition – could initially create frictions in the global environment. In September, policies to reduce energy consumption in Asia led to supply chain disruptions after companies shut down production to comply with requirements.

It is likely that multinational companies will respond to these disruptions by diversifying their supply chains in order to increase their resilience. We already saw such diversification occur in the wake of the SARS pandemic two decades ago.^[17] At the start of this year, around a quarter of major companies said that diversifying suppliers would be their top priority over the next few years.^[18]

But reorganisation of this nature could have implications for the composition of global demand.

For a start, it could accelerate rebalancing away from investment-led growth in major emerging markets, which could make the outlook for external demand more uncertain. Consider that China has contributed, on average, one-third of total global growth since 2005 – more than the contribution of all advanced economies put together.^[19]

Also, firms could end up holding permanently higher inventories as an insurance policy against disruptions. There is already evidence that companies hold higher levels of foreign inputs that are more difficult to source^[20], and changes in these inventories play a key role in the dynamics of international trade. Companies run down inventories when uncertainty rises during recessions – sharply cutting foreign orders^[21] – and trade only recovers when inventories have been stabilised^[22]. A move away from just-in-time supply chains could therefore mean longer periods of inventory adjustment.

Today, faced with historically long delivery times, global manufacturers' stockpiling of inputs continues to run higher than before the pandemic.^[23] We do not yet know if this will become a permanent feature of our economy or if it is just a panic-driven reaction to current shortages. But if it does persist, we could see a more volatile industrial business cycle.

Navigating the post-pandemic world

So how should Europe respond to these changes?

There are two priorities, both of which would help Europe act as an anchor of stability in a more fractured and uncertain world.

As a first priority, we need to be clear that turning our back on trade openness is not the answer.

Even if the protectionist actions of others mean that the gains from trade are no longer as pronounced, the answer is not to respond in kind. Instead, we should use our economic weight to shape openness in a European direction, which means one characterised by being reasonable rather than reactionary, by cooperation rather than conflict, and by redistributing the gains of globalisation to those who have lost out. This is essential to make openness sustainable.

In particular, Europe has immense potential to use the size of its single market to set its values and standards in other parts of the world through open trade – the so-called Brussels effect.^[24] This is already tangible in many areas. But it is naturally strongest where the single market is at its deepest. So, as new sectors emerge, like digital services and the green economy, it is crucial that our single market deepens in tandem so that we can continue to use our domestic strength to exert a positive global influence.

At the same time, we need to protect against risk in areas where our vulnerabilities are excessive. There are vital goods and services that we cannot easily produce at home, and where we need more insurance against external shocks. This lies behind Europe's ambition to increase its "open strategic autonomy". The European Commission has found that 34 products used in the EU are extremely vulnerable to supply chain disruptions given their low potential for diversification and substitution inside the Union.^[25]

To achieve strategic autonomy, some re-shoring or near-shoring of specific sectors – like semiconductors and pharmaceuticals – is probably inevitable in the long term. And the European Commission is already taking measures to strengthen the international role of the euro, which can ultimately make European companies more resilient to the unfavourable actions of others, such as foreign sanctions.

The second priority is for Europe to strengthen its own domestic demand. This is essential to compensate for a more uncertain global landscape in which economies may find it harder to rely on

external demand in times of need. That would make European growth more robust, as well as helping stabilise global growth if the contribution of other economies weakens.

In the decade before the pandemic, Europe tended to import demand from the rest of the world. Annual domestic demand growth was, on average, 2 percentage points lower in the decade after 2008 than in the decade preceding it, and it was slower than that of our main trading partners. This was reflected in a persistent current account surplus.

To reverse that trend, we need to learn the lessons of the past and implement policies that strengthen our internal sources of growth. There are three components to this.

First, we need to steer public and private investment towards the areas of the economy that will generate higher real incomes in the future, namely the green and digital sectors. Green investment is estimated to have a multiplier two to three times higher than non-green investment.^[26] The pandemic has already shifted activity in this direction, but we need to provide the financing and regulatory framework to help the economy adjust smoothly.

Europe already has the ideal tool in place to kickstart this process, in the form of the €750 billion Next Generation EU (NGEU) fund set up in response to the pandemic. The European Commission estimates that NGEU could raise potential output by 3% in some countries by 2024.^[27] But we also need to flank NGEU – which is temporary – with permanent progress on broadening and deepening Europe's capital markets for green and innovative investment.^[28]

Second, unlike after the great financial crisis, fiscal policy support should not be withdrawn until the recovery is more mature. But it should shift from a blanket approach to a more targeted action plan that supports sustainably higher demand. This means that fiscal policy will need to facilitate structural changes in the economy rather than preserving sunset sectors. And, taking a medium-term perspective, it will need to follow a rules-based framework that underpins both debt sustainability and macroeconomic stabilisation.

Third, monetary policy will continue supporting the economy in order to durably stabilise inflation at our 2% inflation target over the medium term. The ECB is committed to preserving favourable financing conditions for all sectors of the economy over the pandemic period. And once the pandemic emergency comes to an end – which is drawing closer – our forward guidance on rates as well as asset purchases will ensure that monetary policy remains supportive of the timely attainment of our target.^[29]

Conclusion


Let me conclude.

Europe, more than any other major economy, reaped the gains of globalisation in the decades leading up to the pandemic. But now we must sow the seeds for a future in which globalisation becomes a more unpredictable terrain.

The benefits of trade and diversifying demand are still there to be had. But they are facing headwinds that Europe cannot ignore. This means we must adapt and change to continue thriving in a global economy and to remain an anchor of stability and peace.

The good news is that we are already on the right path. As Stefan Zweig once wrote, “once a man has found himself there is nothing in this world that he can lose.” Europe's historic response to the pandemic shows that it has found itself.

That allows us to focus on building resilience to face global challenges as and when they arise. In this sense, the pandemic has given us an opportunity and we must seize it.

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