

A closer look

Backlash against globalization: Déjà vu?

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A closer look

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Overview

Globalization is under siege. The increasing integration of the world's labor, product, and capital markets within a rules-based, capitalist system has come under withering attack in many corners of the globe, from both the political left and right, who argue that globalization has increased inequality, hurt the middle class, undermined national sovereignty, and primarily benefitted a global elite who have written the rules in their interests. Calls for protectionism, economic nationalism, immigration restrictions, and disengagement from international trade agreements and organizations are growing louder, part of a broader populist chorus resonating with those who feel left behind not only by globalization, but by seismic technological, social, and demographic changes. Their discontent has unleashed a political backlash, an anti-establishment revolt—"a politics of rage"—that has contributed to the UK vote to leave the EU, the U.S. election of Donald Trump, and the rise of populist, nationalist parties throughout Europe and in parts of Asia too. Opposition to globalization is not the only driver of these trends, but it has certainly played a key role.

We've seen this movie before. The first great globalization wave, in the half-century or so before WWI, sparked a populist backlash too, and ultimately came crashing down in the cataclysms of 1914 to 1945. Of course, the two World Wars and the Great Depression were about much more than just a rejection of globalization, and that rejection was as much a result of these tragedies as their cause.

Still, protectionism and economic nationalism were culprits, and great efforts have been made in the post-WWII era to root them out, by rebuilding a rules-based, open international economic order as a critical piece of a geopolitical system designed to avoid the catastrophes of the past. These efforts have largely succeeded, but that success can never be taken for granted, especially when it comes to free trade. That's because the benefits of trade, while substantial in aggregate, are often diffuse and hard to pinpoint, while those who lose out from trade, though small in number, are easy to identify, usually uncompensated, and understandably vocal. What's more, free trade is easier to vilify than, say, labor-disrupting technology, because the marvels that technology enables make it hard to demonize, whereas attacks against trade fit neatly within broader nationalist tropes. It's little wonder then that free trade and globalization have often been on the defensive, as they are once again today. Although the globalization tide hasn't reversed too much as yet, risks of further backsliding are building. It wouldn't be the first time.

Globalization, take I: From Waterloo to WWI

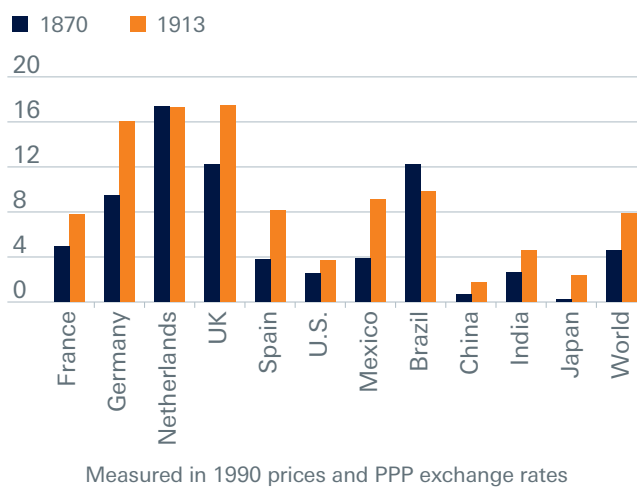
The mid-19th through early-20th Centuries witnessed the first dawning of a global economy. As the Industrial Revolution hit its stride, the costs of transportation and communication fell sharply—think steamships, telegraph, telephone, refrigeration, canals, etc.—effectively shrinking distances and making it easier to transact across

borders. Much of the impact was felt in Europe and North America, where an integrated Atlantic economy emerged, but ripples were evident further afield, including Australia, South America (catapulting Argentina into the league of prosperous nations), and to a lesser extent Asia and even colonial Africa (under Western imperialism).¹ It wasn't only technology that drove this integration—policy was critical too. Increasing support for free trade, including lower tariff and non-tariff barriers, evident in seminal events like the UK's repeal of the corn laws in 1846 (allowing agricultural imports), and the introduction of most-favored nation status (extending the scope of bi-lateral trade agreements to a wider array of nations), coupled with liberal immigration policies in many countries, the remarkable opening and transformation of Japan from a feudal state into an industrial power, the exploitation of colonial raw materials and markets by the West, and the absence of war between the Great Powers from the mid-1870s until 1914 all helped propel this first era of globalization.

The impact was evident on many levels. International trade flourished, with merchandise exports rising sharply as a share of GDP in many countries,² while tumbling transportation costs and steep declines in tariffs combined virtually to eliminate cross-border price differences on many basic commodities, making these markets truly global. Even more striking was the surge in labor mobility. About 60 million Europeans picked up and left for greener pastures in the century after the Napoleonic wars, with the rate of migration especially intense in the three or four decades leading up to WWI. Most of the flow was from the labor-abundant, resource-poor European periphery (Ireland, Italy, Austria-Hungary, Russia, and Scandinavia), where real wages were low, to the labor-scarce, resource-abundant "New World" (especially the U.S., but also Canada, Australia, Argentina, and Brazil). In essence, nations with lots of low skilled, low paid labor "exported" people to countries where labor scarcity made real wages high. Wealthier European nations (e.g., UK, France, Germany) sent people too, but what they sent in greater abundance was capital. Indeed, this era saw unprecedented flows of savings across borders. The UK led the pack of capital exporters, persistently running large current account surpluses and channeling nearly half of domestic savings

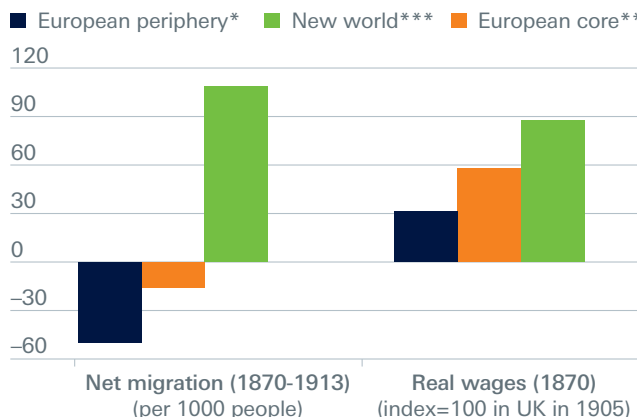
overseas, while Germany and France were not far behind. The lion's share of these flows went to the New World, mostly in the form of portfolio investments to finance infrastructure projects (canals, railroads, mines, etc.), reinforcing the migrations to these lands that helped them harness their expanding frontiers. Capital markets also became more global (or at least trans-Atlantic); the price difference between comparable bonds traded in London and New York, for example, virtually disappeared after the first trans-Atlantic cable was laid in 1866, which enabled information to be transmitted almost instantaneously.³ And with much of the world adhering to a gold standard and allowing unfettered capital flows, exchange rate risk was minimal and independent monetary policies impossible, limiting cross-border interest rate differentials as well.

Figure 1: Merchandise exports as % of GDP



Source: Maddison 2000.

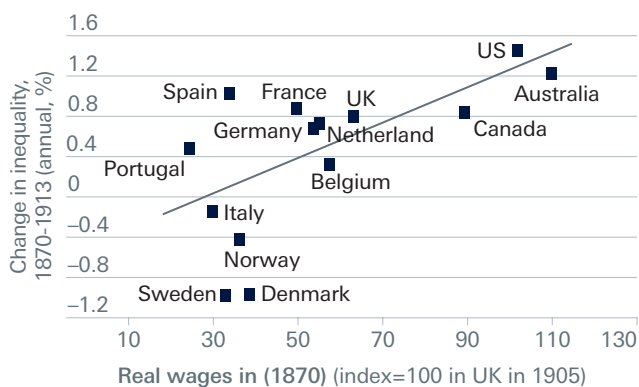
Figure 2: Following the money



* Ireland, Italy, Portugal, Spain, Scandanavia
 ** Britain, France, Germany, Holland, Belgium
 *** U.S., Canada, Australia, Argentina, Brazil
 Source: O'Rourke and Williamson 1999.

The powerful forces that united many parts of the global economy in this era helped reinforce and spread the benefits of the Industrial Revolution. Free trade, cross-border capital flows, and international migration allowed countries to reap the benefits of specialization and enabled resources to go where they were most needed, in search of the highest returns. Far from being a zero-sum game, globalization allowed all countries that were able and willing to participate freely in the international system to benefit. But it also had profound distributional effects. In general, globalization tended to speed income convergence across countries, helping poorer nations grow relatively faster (provided they liberalized and were not colonized), while contributing to widening income inequality within wealthier countries and narrowing it in poorer lands.⁴ Of course, there were exceptions to these patterns. And globalization was surely not their only cause. But it contributed. The real wages of the working class who remained in Europe, for example, got a lift from the reduced supply of would-be workers who emigrated and from the lower prices of imports. The real wages of the lower skilled in the New World were pressured by the influx of immigrants, and industrial companies by the increased competition from abroad, though when capital inflows accompanied this labor influx (as it did to the U.S. and Canada, for example), it helped these already-rich countries buck the convergence trend and grow faster than some of their poorer counterparts. Agricultural interests were buoyed in the New World by the opening of export markets and undermined in Europe by increased competition from abroad.

Figure 3: Inequality rose in the rich, fell in the poor



Source: O'Rourke and Williamson 1999.

Backlash

Partly because of these distributional effects, globalization created a strong political backlash. Not surprisingly, those whose toes were stepped on the hardest, protested the loudest, often amplifying latent nationalist sentiments. Although the technologies that had integrated the world could not be abolished, political pressure grew to roll back the tide of globalization. The first rumblings were heard in the U.S., where the industrialized North boosted tariffs to raise revenue during the Civil War and then kept them high for decades thereafter to fend off competition from overseas. In Europe, agricultural interests began succeeding in their push for protection as early as the 1880s, and even manufacturing industries began to seek refuge behind tariff walls. The UK was relatively better disposed to free trade, in part because its powerful financial and industrial interests supported it, but by the early 20th Century protectionist cries were heard there too, as the country's industrial base started to be challenged more effectively from abroad. On the immigration front, policy began to shift away from welcoming newcomers toward steadily increasing restrictions, culminating in the U.S.'s literacy tests (1917) and tight quotas (1921). The main impetus here was pressure from the working class, who were gaining power politically and whose position was threatened by the influx of immigrants, though nativist sentiments played a role as well.⁵ Ultimately, globalization collapsed during the upheavals of 1914 to 1945. Roiled by two World Wars and the Great Depression, the global economy imploded, and nations turned dramatically inward, raising tariffs to autarkic levels, imposing draconian controls on capital flows, and restricting immigration to a trickle. The first era of globalization was over.

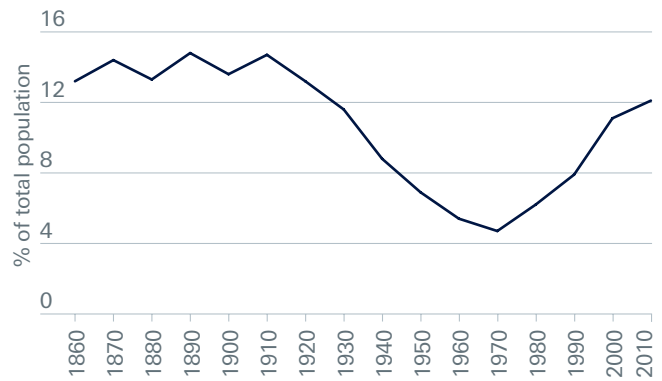
Globalization, take II: Picking up the pieces

In the aftermath of WWII, the U.S. led an effort to rebuild and expand an open, integrated, global economic order. A set of supranational organizations (IMF, World Bank, GATT) were created to co-ordinate policies, support growth, and help oversee the transition away from protectionism, while a fixed-exchange rate regime centered on the U.S. dollar was established to replicate the stability afforded by the gold standard (albeit with greater flexibility and scope for adjustment). Slowly but surely tariff and non-tariff barriers were reduced, both within the multi-lateral

GATT framework and regional agreements like the European Community, immigration restrictions were eased, and capital controls were lifted. In fact, it was the lifting of these controls, coupled with the growing unease that many countries felt at having to subordinate their monetary policies to the U.S. (which had allowed inflation to rise by the early 1970s), that eventually made the fixed-exchange rate system unviable. But the globalization trend continued under floating exchange rates, and got a major additional boost when the Cold War ended and many formerly closed economies (e.g., China, Eastern Europe, India) opened up, liberalizing their economies and becoming part of the global economic system, adopting standards set by the WTO (the successor to GATT). The revolution in information and communications technologies also helped, dramatically lowering the cost of transferring information, goods, and ideas across borders, improving efficiency, enabling global supply chains to proliferate, and further integrating the economies of the world. In short, modern globalization has been spurred by some of the same forces that powered the pre-WWI epoch: New technologies, an open, free-trade, rules-based world economic system underpinned by the leading power of the day, and a period of general peace among major countries.

The results are all around us. International trade has revived markedly since WWII, and especially in the decades leading up to the financial crisis, with export shares in many countries eclipsing those seen in the pre-WWI era, a wider range of products (including services) being exchanged, and many more industries becoming linked across borders by integrated supply chains. International capital flows have also reached new heights, and financial markets have become vastly more integrated, with a broader array of financial claims now traded internationally and large current account imbalances once again prevailing, as countries with surplus savings are able to channel those surpluses abroad, empowering others to invest more at home than their domestic savings would allow. As with trade, the free flow of capital across borders enables resources to be allocated more efficiently. The same is true of labor mobility, which has rebounded too (albeit not back to rates prevailing in the late 19th/early 20th Centuries), often fueled by young workers moving from emerging economies to richer countries, where aging populations and ample capital offer these migrants better opportunities.

Figure 4: Foreign-born population in the US

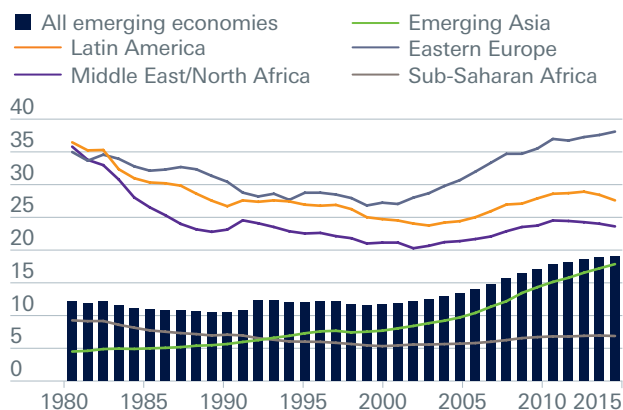


Source: U.S. Census.

Modern globalization has done for the Information Age what the integration of the global economy prior to 1914 did for the Industrial Revolution—reinforce and diffuse the benefits of technological change to many parts of the world. And it has contributed to an even more remarkable period of global economic growth. But once again, the benefits of that growth have been unevenly distributed, in ways that often parallel the pre-WWI era. In general, poorer countries that have liberalized and become part of the global system have tended, at least over the past couple of decades, to grow faster than more advanced economies, though a few regions (emerging Asia and Eastern Europe) are largely responsible for this catch-up, and glaring gaps in average living standards between the emerging and the advanced worlds persist. Within countries, inequality has rebounded sharply over the last three or four decades, especially in advanced economies, where upper-income people have reaped disproportionate gains, and metrics of inequality have in some places retraced to levels not seen since the early 20th Century. Inequality trends within poorer, emerging economies are more mixed; those that have grown the fastest (e.g. China), have tended to see inequality widen, bucking the pattern from the earlier epoch of globalization, though others, including many in Latin America that weren't as poor to begin with and haven't grown as rapidly, have seen inequality narrow.

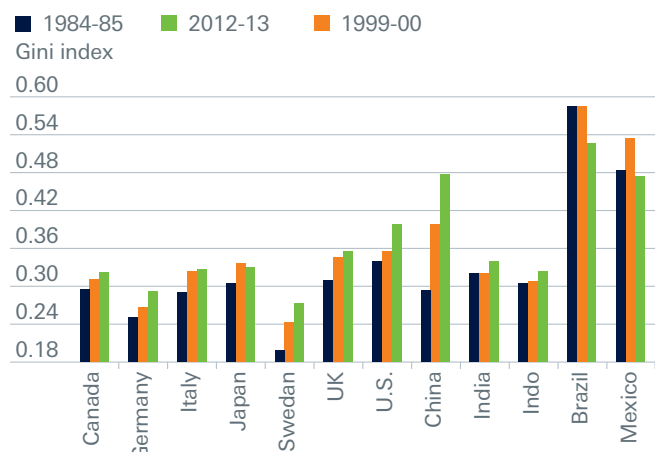
Globalization is not the only or even most important driver of these trends. Yes, opening up to the world, becoming part of global supply chains, and accessing the markets and technologies of the advanced economies has helped some emerging economies grow rapidly, but a combination of other, more domestic factors—starting from low levels

Figure 5: GDP per capita (PPP basis, % of US)



Source: IMF.

Figure 6: Inequality has risen within most countries



Disposable income, after taxes and transfers for advanced economies Household income for emerging economies.

Source: OECD, World Bank.

of human and physical capital, enjoying favorable demographics and high rates of domestic saving and investment, adopting stable macroeconomic policies and more inclusive, market-oriented economic systems—have also been critical in catapulting some emerging economies forward. As for the rising tide of inequality within countries, that too has myriad causes. Most studies suggest that technological change has played the leading role here, tilting the demand for labor away from the low skilled toward the high-skilled, faster than the supply of skills has increased, thus boosting the wage premium for those with key skills and exacerbating inequality. Social trends—including the increased prevalence of single-headed families, especially among the poor, and the tendency of high earners to marry other high earners—have also boosted inequality, as perhaps have government

policies on taxes, transfers, and regulations. That's not to say globalization has been an innocent bystander. It surely has had distributional effects, harming some sectors in advanced economies by exposing them to greater competition from abroad, especially sectors that rely heavily on lower- and semi-skilled workers. Also, a more open world may have amplified the effects of technological change in lifting the earnings of those with greater skills by giving them a larger, global platform to market their wares. But in countries that are still relatively closed, like the U.S., these effects have generally been found to be modest in aggregate, bigger perhaps than in the past but still less crucial in driving inequality than things like technological change.⁷

When it comes to generating criticism, however, globalization takes the prize—hands down. To paint technology as a villain is to risk being considered a Luddite. Even if it were possible, few would want to undo, say, the mechanization of agriculture, or electrification, the automobile, information technology, and so forth, even though these revolutionary engines of growth have caused enormous disruption, sometimes rendering entire industries and worker skill sets obsolete. Globalization makes a far easier target, because its benefits are spread more thinly and less transparently, while its victims, often companies and workers in industries exposed to foreign competition, are in plain sight and usually not helped enough to make up for their losses. Attacks against globalization are also the natural, populist course.

Backlash, all over again

That's certainly true today. The recent pushback against globalization is part of a broader populist movement on both sides of the political spectrum. Populism of the right paints globalization as the handmaiden of establishment elites, and taps into nationalist sentiments that see sovereignty and domestic interests as being eclipsed by international institutions and rules—especially ironic in the U.S., which has played the leading role in establishing those institutions and rules. Populism of the left also focuses its anti-globalization ire at elites, though typically the moneyed interests, and argues that globalization not only harms the working class in advanced economies, but also the poor in emerging economies, not least by undermining their

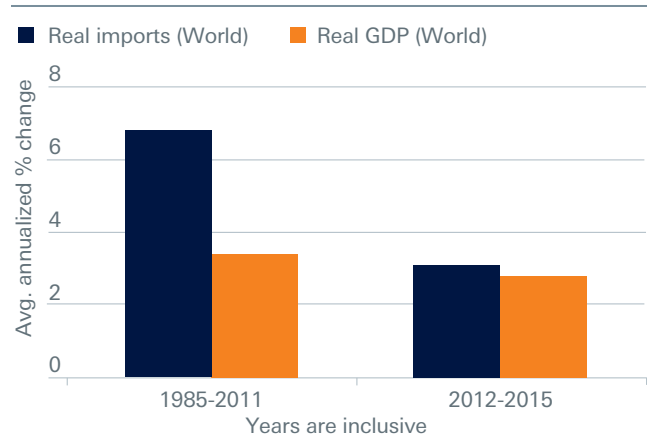
environmental, labor, and political standards—ironic because being part of the global system is what has helped so many poor countries improve their lot, and often adopt better environmental and labor standards and greater political inclusiveness as they escape the shackles of poverty. These arguments notwithstanding, the critics of globalization persist, and the populist drumbeat grows louder.

Globalization in retreat?

It's starting to have an effect. Not just politically, where populist, anti-globalization sentiments have helped tip recent elections in Europe and the U.S. But economically too, where signs are building that globalization itself may be losing momentum. International trade has slowed, barely outpacing global GDP growth in recent years after running at more than twice its pace in the quarter-century or so from the mid-1980s. Migration has also cooled; in the U.S., for example, the share of the population that is foreign-born has decelerated in recent years. On the financial side, evidence is more mixed, with international bank-related capital flows in decline since the financial crisis, but overall financial integration continuing to advance, reflecting large cross-border capital flows to finance current account imbalances and in response to substantial differences in interest rates across countries. So it's not as if globalization has gone into reverse; more like a shift into a slower gear. And some of it may be transitory, owing to cyclical factors like weak investment spending, which tends to be trade intensive, the collapse in commodity prices in 2014-'15, which hit Asian exports especially hard, and the lingering effects of the financial crisis and Great Recession, which depressed the demand for immigrant labor in many advanced economies. More enduring forces may be at work, though, including diminishing returns from the expansion of global supply networks and slower trend growth of the populations of potential migrants in many emerging economies. But what's most worrying is that policies have been shifting against globalization. Tariff reductions have stalled, non-tariff barriers and other trade discriminating measures have been on the rise, more countries have been limiting immigration, some (including China) have tightened capital controls, and the adoption of trade pacts has slowed, as evidenced most prominently by the failure of the Doha round of trade liberalization and

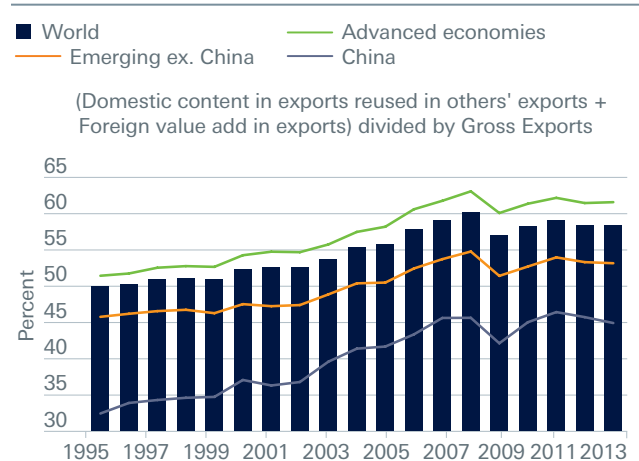
the U.S.'s recent decision not to ratify the TPP. And this may be just the beginning. The TPIP negotiations seem to be stalling, the U.S. is threatening to revamp NAFTA and possibly initiate punitive tariffs against China, while pressuring domestic firms to alter their economic decisions and hinting that it may reevaluate the U.S.'s role in underpinning the global economic and geopolitical order. In Europe, the possibility of a hard Brexit looms, as do the risks of nationalist parties gaining power on the Continent and possibly scuttling the EU. In parts of Asia, mercantilist trade sentiments are on the rise, as are geopolitical rivalries, which may intensify if the U.S. reduces its role in the region.

Figure 7: Trade slowdown



Source: IMF.

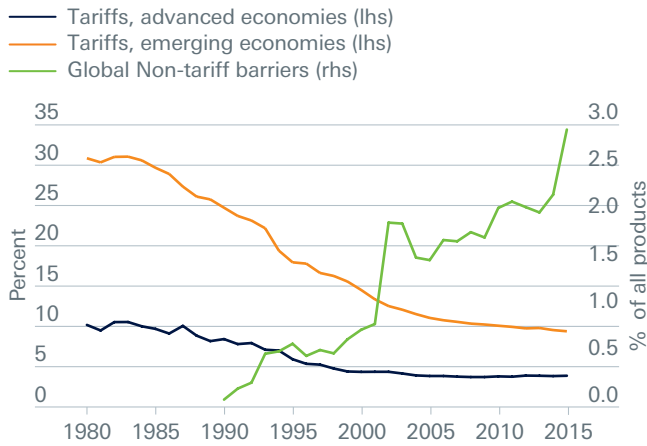
Figure 8: Global supply chains peaking?



Source: IMF.

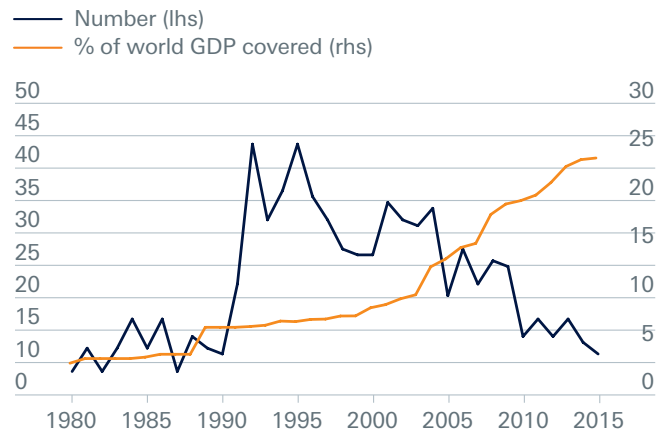
So far, these are mostly risks. Cooler heads may well prevail. And the technologies that have enabled a more integrated world cannot be undone. But the policies that underpin free trade and a rules-based, open international economic order can be reversed, as history cautions. Globalization must never be taken for granted. Its benefits have to be better articulated to the public, the risks of abandoning it more clearly spelled out, and the minority who are hurt by free trade and open markets perhaps better compensated for their losses. The stakes are high. Much hinges on reversing the age-old scourges of populism and anti-globalization.

Figure 9: Free trade momentum slowing?



Source: IMF.

Figure 10: Fewer free trade agreements



Source: IMF.

¹ See, for example, O'Rourke, Kevin H., and Jeffrey G. Williamson (1999). *Globalization and History: The Evolution of a Nineteenth Century Atlantic Economy*. MIT Press.

² Maddison, Angus (2001). *The World Economy: A Millennial Perspective*. OECD Development Centre Studies.

³ Garbade, K. D., and W.L. Silber (1978). "Technology, Communication, and the Performance of Financial Markets," *Journal of Finance*, 33.

⁴ Williamson, J. G. (1996). "Globalization, Convergence, and History," *Journal of Economic History*, 56.

⁵ Higham, John (1955). *Strangers in the Land: Patterns of American Nativism, 1860-1925*. Rutgers University Press.

⁶ See, for example, OECD (2011). "Divided We Stand: Why Inequality Keeps Rising," OECD Working Paper.

⁷ See, for example, Autor, David, David Dorn, and Gordon H. Hanson (2013). "The China Syndrome: Local Labor Market Effects of Import Competition in the United States," *American Economic Review*, 103 (6).

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All opinions and forecasts are as of the date of this document, subject to change at any time and may not come to pass.

Definitions

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom from the European Union.

The General Agreement on Tariffs and Trade (GATT) was formed soon after World War II ended with a primary purpose of increasing international trade through the elimination or reduction of various tariffs, quotas and subsidies, while maintaining meaningful regulation in order to boost economic recovery.

Gross domestic product (GDP) is the value of all goods and services produced by a country's economy.

The International Monetary Fund (IMF), created in 1945 and headquartered in Washington, D.C., is an organization of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

North American Free Trade Agreement (NAFTA) is a three-country accord negotiated by the governments of Canada, Mexico and the United States which provided for the elimination of most tariffs on products traded among the three countries.

Trans-Pacific Partnership (TPP) was a multinational trade agreement that aims to deepen economic ties between the U.S., Japan, Malaysia, Vietnam, Singapore, Brunei, Australia, New Zealand, Canada, Mexico, Chile and Peru to boost growth.

Transatlantic Trade and Investment Partnership (TTIP) is a proposed trade agreement between the European Union and the United States with the aim of promoting trade and multilateral economic growth.

World Trade Organization (WTO) is the only global international organization dealing with the rules of trade between nations.

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