Comment Boundary changes

- *The Great Recession has had a profound influence on globalisation and the role of the state*
- *The ramifications for policy and beyond have been both complex and sometimes unexpected*
- *For now, the process of global integration retains considerable momentum*
- *But there are risks of setbacks, should recovery remain so hesitant and uneven*

The Great Recession, globalisation, and the role of the state

An intense period of global integration …

Globalisation can be defined as the process by which national and regional economies become more integrated through the international networks of trade and capital flows, communications, immigration, and transportation. It has long been impelled by human innovation and technological progress. But arguably the two most impressive aspects of the most recent iterations of this process have been a collapse in communications costs and the assimilation of the developing world, and in particular rapidly growing, populous and geographically large countries – China and the other BRICs – into a global economic system that had previously been overwhelmingly dominated by the OECD economies.

The net result of globalisation has been greater competition, and greater productivity through economies of scale and the division of labour. Meanwhile the creation of larger and more diversified markets has increased the access to capital, technology, and cheaper imports, and has increased the demand for exports. It has helped propel economic growth, rising living standards, the spread of democracy, and human progress. Admittedly, it has also caused dislocations, and there have been some 'losers', although often these disturbances and their associated casualties have been exacerbated by the shortcomings of countries' institutional architectures, incentive systems, and structural policy frameworks. Moreover, those countries that have eschewed globalisation the most have tended to fall furthest behind in the development race.

Globalisation has ebbed and flowed as the pace of technological change and its assimilation have varied. Moreover, its tempo and complexion have been bound up with the business cycle, with cyclical downswings and their immediate aftermaths tending to recalibrate it, slow it down, or even temporarily send it into reverse. Although major recessions can be a powerful catalyst for innovation, investment spending is typically the biggest casualty of the associated collapse in aggregate demand. Steep downturns also often provoke myopia and parochialism, if not political desperation, none of which is conducive to good economic policymaking.

… has been recast by the Great Recession

The recent Great Recession is no exception. As much of the world, and especially its more advanced economies, first slumped and then struggled to recover, so the relationships between individual states and globalisation changed, and the pace of globalisation itself slackened. But the manner in which these adjustments occurred was complex, often straying in unexpected directions.

It is therefore worth reviewing how all this has played out, and what may happen.

Changes since the global financial crisis

Many old certainties have been swept away

Besides provoking sharp downward adjustments in the volume of world trade, foreign direct investment, and cross-border banking flows, the Global Financial Crisis dealt a heavy blow to the economic status of much of the developed world, in both relative and absolute terms. Sluggish growth, if not outright stagnation, acute financial sector dysfunction, heavy debt burdens weighing on both the private and public sectors, high and often still rising unemployment, and growing concerns about income inequality, have led to a loss of trust in finance, markets, and governments.

Meanwhile, the economic policy environment has changed out of all recognition. States have perforce acted as shock absorbers, in the process encroaching on areas historically associated with governments of the Left and financial repression.

The distribution of economic power, reflecting its chronic underperformance, has shifted from the developed world towards the emerging world which initially experienced an upsurge in self-confidence. However, this has since faded in the face of continued economic uncertainty.

The implications

Institutions and policy priorities are being challenged

All this has resulted in numerous new challenges at the global level. These include pressures on the multilateral institutions, for example through the failure to complete the Doha Round of trade negotiations; changes in the international economic order, such as the eclipse of the G7 by the G-20; a greater focus on issues of resource (including food) security and scarcity; and arguably the emergence of a global governance gap, in that many of the new leading economies either do not want to lead politically or are unable to do so.

For many countries it has also meant a reduced appetite for further liberalisation or deregulation (except in finance) and a greater tolerance for government control and market intervention. Nationalisation is resurgent. And the IMF and other international bodies have legitimised many of these interventionist departures, not least the institution of capital controls.

However, the story has not been universally regressive. Explicit trade protection has been the dog that (so far at least) has not barked. Admittedly, unconventional monetary policy initiatives have exerted occasionally significant influences on exchange rates, and there has been lazy talk of "currency wars", but average tariff levels have changed little. What is more, in much of the euro area in particular the crisis and its aftermath have seen the implementation of important, long overdue, structural reforms, mandated as part of financial bailout packages. If sustained, these stand to contribute positively to growth and globalisation over the longer term.

Notwithstanding all these recent changes of approach to policy-making, therefore, the world economy remains deeply connected and closely integrated. Technological innovation and assimilation continue to play a critical role in maintaining and enhancing these ties, and governments, so far at least, have shied away from some of the more self-destructive palliatives.

Consequences for the relationship between states and markets

The state's role has evolved enormously

There have been large and continuing shifts in the lines between states and markets, with some significant expansions in the role of the state. But these policy departures have generally been embarked upon with reluctance, generally with the stated intention to reverse them in due course.

The role of the state has evolved in many areas:

I. Fiscal policy, where a desperate 'Keynesian moment' was followed by fiscal tightening and a continuing debate over its pace and indeed its overall veracity, especially given that many sovereign borrowing costs are at historically low levels;

II. Monetary policy, which has become increasingly unconventional and radical, in part to take over where fiscal policy has been thrown back into reverse. OECD policy rates are now typically at or around the zero bound, there has been increasing resort to large scale asset purchases, including those of private sector instruments, and central bank balance sheets have expanded dramatically.

III. Macroprudential supervision, which has been tightened, often in the context of international efforts to establish a common approach.

IV. Trade policy, where there has been a shift away from, if not the abandonment of, attempts at multilateral agreements, in favour of preferential deals and, more recently, mega-regional trade agreements.

V. The emergence of new approaches to, and fora for, international co-operation, such as the G-20 and Financial Stability Board (FSB).

Social contracts are being renegotiated

At the same time, there has been growing pressure on the often long-standing social contracts between states and their citizens. New demands for social protection arising from the enduring downturn, the perceived downsides of globalisation, and the consequences of aging populations have run into new constraints given the erosion of tax bases and the need to service large and still rising public sector debt. The net result is the gradual renegotiation of these contracts, mainly through higher retirement ages and changes to benefit rules.

Finally, the shift in the balance of economic power towards the emerging economies has resulted in a greater role for states where there is a relatively greater emphasis on state-owned enterprises, sovereign wealth funds, and state-owned banks. Consequently, there has been a rise in state-led global activity in terms of both trade and investment flows.

A constraint on state actions and policies; but also a facilitator

Governments still retain considerable freedom of action …

Increasing international economic integration can limit states' actions and choices. But it can also facilitate advancement, given for example the opportunities that it provides for catch-up growth by enabling certain development stages to be leapfrogged.

Increases in the mobility of labour and capital certainly do constrain the ability of governments to raise revenue and deliver spending programmes, especially now that in so many countries it is harder to substitute debt for taxes. There are also implications for the equity of the tax system. But these constraints should not be exaggerated. Governments can still use the tax system to shape incentives should they so choose, provided that domestic politics allow.

Globalisation can involve the imposition of restrictions through international regulations and standards, which serve to limit policy space. But equally it can make it possible to benefit from importing higher standards and new approaches. Hence, while 'races to the bottom' can be a risk, it is also possible to think of examples of 'races to the top' in areas such as accountancy and the spread of communications technology.

Moreover, the diversity of economic models and choices worldwide suggests that there is still significant scope for policy differentiation and experimentation. And while globalisation can sometimes be a constraint on policy choices, it can also serve as a convenient excuse for what are really national policy failures.

Policymakers can learn from successful economic models

… while some economic models have flourished…

Not every country is in a post-crisis funk, not every pre-2007 policy regime has been abandoned, and not every economic model has been junked. There are success stories to go alongside today's failures and cautionary tales.

For the most part, the emerging economies proved to be resilient in the face of the economic and financial shocks to the developed economy core that, in previous decades, would have been expected to derail their growth prospects. This suggests that they must be getting policy right to some extent – or that they started from a favourable position e.g. with huge reserves, the result of lessons learned (painfully) following the 1998 crisis.

However, the general lessons from emerging economies for rich economies may be limited. The overall set of policies that might help to deliver rapid and successful catch-up growth is unlikely to be the same as those required to maintain growth at the global frontier. Nevertheless, lessons can be learned, such as the critical role of education in nurturing output potential, and the enduring importance of building macroeconomic resilience.

… but their transferability may be limited

Not every rich country succumbed to the crisis. Germany has proved more resilient than most, and Canada and Australia, benefitting from their status as resource-rich developed economies, managed to avoid financial meltdown. The Nordic economies too have come through relatively unscathed. But just as there are dangers in looking to the developing world for answers, so there are risks in looking elsewhere in the developed world for salvation.

External models are often idiosyncratic, subject to their own underlying fragilities, and their viabilities can have a limited lifespan. There is a risk that a country seeks to embrace the latest 'flavour of the month' development model just as it reaches its sell-by date. Recall, for example, Britain's early and mid-60s efforts to adopt French indicative planning; or the swathes of US businessmen who headed across the Pacific to learn about Japanese business practices in the 1980s. Both proved ill-timed and misguided. Alternatively, imagine the broader economic and political consequences if every nation sought to follow Germany's neo-mercantilist model.

Neither should it be forgotten that economies are often prisoners of their own history. The development of their institutions and the habits of their population become deeply entrenched and resilient to change. Often it has taken a traumatic shock, such as a war defeat or the most persistent of policy re-orientations, to effect a lasting transformation.

Perhaps the soundest conclusion, therefore, is that while an entire external model may not be replicable, the adoption of some carefully chosen individual policy experiences probably can be.

The role of global economic governance

Global governance is in a state of flux

Globalised markets and increased economic spillovers imply greater benefits from international economic co-operation, even as the shift in the balance of power makes it more difficult.

The presence of different economic models, and in particular quite different choices about the role of the state in the economy, represent potential sources of friction in trade and investment policy. These risks need to be managed.

The G-20 in many ways symbolises both the change in the international economic order and the difficulties in making the new order work. Expectations of what the G-20 can deliver tend to be overblown. There is a need to be more realistic. In the immediate future, the payoffs from the G-20 and similar initiatives in terms of concrete policies are likely to be modest. But that should not diminish the importance of continuing international discussion and the need to nurture it, especially should the world again be confronted by serious global economic trauma.

The risks ahead and what to watch for

Many governments may yet face more serious challenges

Overall, while the economic environment and the relationship between the state and markets has changed in so many ways since 2007, nevertheless the momentum of globalisation has, so far, proved remarkably resilient. But it would be unwise to be complacent. Social and political stresses often lag the business cycle, especially when the upswing is as hesitant and uneven as the current one, and when it is likely to remain so.

There are perhaps three overriding risks and areas on which to keep an eye in the period ahead.

The first is that the more traditional forms of trade protectionism make a (belated) comeback. The post-war multilateral trade and payments system is very much an American construct. As the economic and financial hegemony of the US is increasingly circumscribed, its ability to sustain the system in its own image is likely to be reduced.

- Watch for: an escalation in anti-dumping cases at the WTO; increasing resort to non-tariff barriers to trade; and, ultimately perhaps, recourse to the sort of autarkical trade policy responses that characterised the 1930s.

The second risk is that of deepening financial repression. Indeed, it would be surprising were there to be any viable escape route from the onerous burdens of public sector debt falling on the advanced nations without it.

- Watch for: a growing addiction to variations on the theme of QE; increasing use of regulation or macro-prudential policies that oblige large savers and their agents to favour “low risk assets” to create a captive market for domestic sovereign debt; and increasing application of capital controls.

The third risk is growing regionalisation, fragmentation, and weakening of global governance bodies. The BRICS and other emerging economies are already setting up a number of entities designed to co-ordinate their activities in their own interests.

- Watch for: signs that these are multiplying, and how the members conduct themselves. The danger is that they become an arena for the airing of frustrations with the advanced economies and the old economic order, rather than a platform for constructive, multilateral, dialogue.

The US may return to (partial) isolationism

Each of these risks could easily result in a new phase of US isolationism, especially following its series of less than successful overseas military operations, and given that the country is moving back towards self-sufficiency in food and energy. ■

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