

Global Letter A world of three regions



The world's big regions are edging towards autarchy. The smaller countries will be the main losers.

Anyone born after the 1940s might well consider the natural economic order to be unfettered international trade; ever-declining tariffs; progressively freer movement of capital; near-unrestricted repatriation of profits; binding resolution of trade disputes in international courts.

But such is not the normal scheme of things. The past seventy years were the exception, not the rule: and now, in a form of economic entropy, the world is reverting, for the moment at least, to its former chaotic, disorderly, often confrontational, configuration.

There is no telling how far all this will go: but it is worth conjecturing how matters might be were present escalating protectionism to culminate in a world segregated into three or four principal trading regions – the US, the EU, China, and perhaps India.

The view from the core

The path to regional autarchy would lead increasingly to aggregate demand in each region being diverted from imports to domestically-produced output – US airlines switching to Boeing, the Europeans to Airbus, the Chinese to Comac¹ – that sort of thing. This would entail some loss of consumer welfare through reduction in choice, and doubtless there also would be increases in production costs and hence prices, and thereby some reductions in living standards.

However, the absolute level of demand and output might be a different story: in each of the three or four regions this might change comparatively little, lost export sales being offset by increased demand for domestically-produced output.

How far this process of increasing autarchy could go before it started to hurt real incomes significantly is debatable, but probably it could go quite a long way. After all, US exports did not reach even 5% of US GDP until 1960, and were almost always below the 10% mark until as late as the 1990s. Yet the US economy functioned satisfactorily at this modest degree of openness.

Perhaps the greatest costs would be those of adjustment, as resources switched from servicing foreign demand to meeting domestic demand – the more so if the structural change were rapid.

Even with all that, however, it is not obvious that costs would necessarily rise hugely: many producers in these ultra-large regional markets would continue to enjoy the gains from specialisation and economies of scale – not only in production, but also in marketing and R&D.

Peripheral perspectives

Other economies however – which is to say potentially much of the rest of the world – would stand to suffer, and considerably.

In contrast to the three or four huge regional markets, those of all other countries are quite small, offering little opportunity for economies of scale in production. South Korea's domestic market for autos, for example, is only one-fifth the size of its total auto production.² Unless such countries could maintain access to at least one of the major markets, output would be scaled back, costs of production and prices would rise considerably, and real incomes would suffer commensurately.

These economic influences would have important political ramifications. Beholden to the large regional economies for access to their markets, the smaller countries would be vulnerable to pressure from the large regional powers. At a minimum they would become economic rule-takers. They would also likely find the large regional powers inclined to wield their considerable economic power to political ends. Suasion, as exerted for example by China over its African commodity suppliers, the US over Mexico and Iran, could become more commonplace. What a moment for the UK to elect to leave one of the world's three largest markets, to which it has unfettered access!

Paying the price

At present, there may be little concern over such possibilities. But matters may change, and possibly quickly. One sign would be downward pressure on the currencies of the more peripheral economies vis-à-vis the major currencies. Another would be discounted valuations of companies operating outside the big regions, particularly when heavily dependent on exports. ■

¹ The Commercial Aircraft Corporation of China, which already produces a competitor, the C919, for the Boeing 737 and the Airbus A320, and is planning a wide-body aircraft, the C929.

² Global auto sales by Hyundai, Kia, GM Korea, Renault Samsung and Ssangyong totalled 8,231,418 vehicles in 2018, while domestic car sales reached 1,545,604 units. See Xinhua, 2019. *S. Korean carmakers' global auto sales rise in 3 years in 2018*, 2 January. Available at http://www.xinhuanet.com/english/2019-01/02/c_137714856.htm [Accessed 27 May 2019]

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