CEPS COMMENTARY
Thinking ahead for Europe

The Globalisation Litany

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One refrain heard over the last decades has been that the dominant trend is 'globalisation'. The world economy was integrating as trade increased year after year more than overall income. But over the last few years this trend has stopped. Trade growth has dramatically slowed and is no longer much higher than income growth, which itself has slowed down. This slowdown in trade is seen as dangerous for the proponents of globalisation. All the major international institutions have recently published studies of the slowdown in trade, almost invariably ending with calls for action to reverse the phenomenon to get globalisation back on track.

In my view, however, their diagnosis is wrong, and there is little to be worried about the slowdown in trade.

The best example of the globalisation litany might be a recent report from the International Monetary Fund,[1] which asks: What's behind the slowdown?

It is telling that the IMF could not identify any significant new barriers to trade as the cause for the slowdown in trade. Its economists attribute most of the slowdown to the global decline in investment. But the presumption that more trade is good is so strong that this analysis is followed by a call for action to revive the "virtuous cycle of trade and growth".

Does it matter that one understands the reason why trade first expanded over the last decades and why it is now retreating?

It does, because a poor understanding of the drivers of globalisation has led to a hype with implicit promises that could never be met. The stark contrast between this hype and the poor economic performance of many advanced countries is one of the key factors of the current populist backlash against trade in general.

Economists have long made a strong case for trade liberalisation. Dismantling trade barriers should allow countries to specialise in sectors in which they are more productive by engaging in a mutual exchange of goods that benefits both sides and leads to higher living standards. This classic narrative of trade liberalisation fostering growth worked when the high trade barriers that had been erected during the war were gradually dismantled in the decades of the post-war period (from the 1950s to the 1980s).

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[1] IMF, "Global Trade: What's behind the Slowdown?", *World Economic Outlook*, Washington, D.C., October 2016 (http://www.imf.org/external/pubs/ft/weo/2016/02/).

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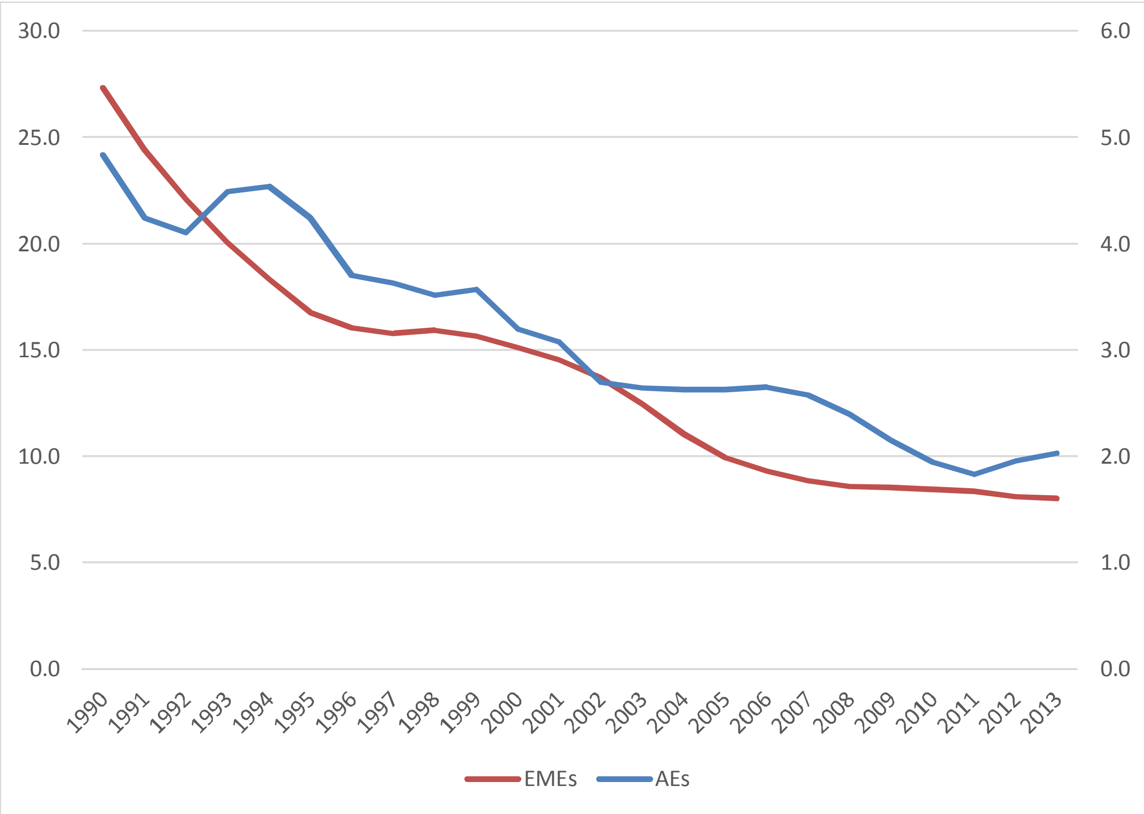
But these classic gains from trade for advanced economies were pretty much exhausted by the late 1990s, when tariffs and other trade barriers had been reduced to a very low level as shown in the figure below. The average tariff rates of the EU and the US, for example, are now only a little over 2% and both have so many exemptions from tariffs that the effective rate is only about 1%.[2]

Average tariff rates for advanced economies (AE) and emerging market economies (EMEs)



Note: AEs = G7 plus Spain; EMEs = BRIIC plus Mexico and Korea.
Source: Own calculations based on World Bank data (WDI database).

Moreover, economic theory also implies that the gains from lowering trade barriers diminish more than proportionally when the remaining barriers are low. It should thus have been clear by the end of the 1990s that the additional gains from eliminating the remaining barriers would be much smaller than those gained over the previous decades.[3]

[2] In 2013, the EU budget recorded about €6 billion in customs revenues. Since member states can keep ¼ of the revenues, this implies that about €20 billion were collected in customs. With extra-EU imports amounting to €1,800 billion, this means that the effective amount paid by importers was only about 1.1% of imports, or about one-half of the Common External Tariff rate (see http://ec.europa.eu/budget/financialreport/2015/revenue/index_en.html).

This large difference between the tariff rates and the revenues collected arises because products from many countries enter the EU tariff-free – either because there exists a bilateral free trade agreement, or because of the EU's system of preferences under which most poor developing countries are granted tariff-free access.

For the US, one can observe a similar discrepancy between the average tariff and the revenue actually collected (see https://en.wikipedia.org/wiki/Tariffs_in_United_States_history).

[3] One could of course object that there remain considerable other, so-called non-tariff barriers (NTBs) as obstacles to trade. But these barriers are often intrinsically linked to national preferences for consumer protection and other social choices. Their removal thus faces high political costs as the mounting opposition to the Transatlantic Trade and Investment Partnership (TTIP) shows.

But this more modest narrative was not accepted. On the contrary, the huge expansion of trade in the 2000s led to the 'hyper-globalisation' narrative with its implicit promise of huge gains for everybody.

But few dared to explain that this 'hyper-globalisation' was not driven by a dismantling of trade barriers, which were already low, but was mainly due to a commodity-price boom. As commodity prices increased trend-wise, the value of world trade increased because oil, and other commodities, account for a large proportion of global trade. Moreover, as the oil producers experienced rising income, they tended to import more, thus leading to a natural increase in the volume of trade. In this view, the recent slowdown of trade is just the mirror image of the huge increase in trade over the last 20 years on the back of ever-increasing commodity prices.

But back during the heyday of hyper-globalisation, no responsible politician dared to explain that under these conditions globalisation would have different implications (for advanced economies) than previously: this new globalisation meant lower living standards in advanced countries as higher commodity prices diminished the purchasing power for OECD workers.

This is indeed what happened: trade expanded with higher oil and other commodity prices, but growth did not increase even before the financial crisis hit.

The mis-selling of globalisation was similar both sides of the Atlantic. But the US case is somewhat different from Europe because the US is also a significant producer of oil and gas. This meant that for the US as a whole the increase in commodity prices was less relevant than for Europe. But the loss of purchasing power to workers from higher oil prices was if anything even larger in relative terms in the US than in Europe, since in Europe high sales taxes meant that even a doubling of crude oil prices led only to a modest increase in prices at the pump. Moreover, the gains from higher oil prices went to a small concentrated class of producers (and the small number of workers in this sector).

However, given the position of the US as a major crude-oil producer, the country had less need than the Europeans to increase its exports of manufacturing to balance its external accounts. Instead, the US let its external balance deteriorate. This means that US manufacturing workers got squeezed on two sides: gas prices went up and manufacturing stagnated. The pressure on the manufacturing sector was further increased by the emergence of a large trade deficit, due mainly to lower exports of manufacturing products.

This 'double whammy' hit workers at about the same as NAFTA was coming on stream. Although most studies show that the net job losses due to NAFTA were limited, this coincidence created the strong impression that globalisation in general, and NAFTA in particular, was a raw deal for American workers. This has then opened the space for demagogues like Donald Trump who promise more prosperity by erecting new trade barriers.

Having misunderstood the causes of the extraordinary growth of trade over the last few decades, political elites over-sold 'globalisation'. The current backlash is understandable if one considers the gulf between the hype and the fall in living standards for many workers. The present slowdown in trade volumes is due to lower commodity prices. It should be welcomed, not bemoaned. New barriers are certainly not warranted, but political leaders should stop insisting on the narrative that more trade is always a sign of good times and that less trade is always bad.