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WITHER GLOBALIZATION?

Globalization – for good or ill – was an unstoppable freight train over the past several decades, running roughshod over whatever got in the way. Lately, however, it has begun to lose some steam. Global trade growth is suddenly on a much slower trajectory, raising serious questions about whether this deceleration is a mere blip or a signal of more to come. In an effort to answer that question, this report delves into the backstory of globalization, investigates the extent of the trade deceleration, why trade has slowed (Exhibit 1), the outlook going forward and what it all means for the global economy.

In brief, our findings are that around half of the changes to the trade dynamic are structural in nature, meaning a permanent loss. But the other half appears to be cyclical, suggesting at least a partial rebound in export growth in the coming years as global growth lifts off. This mixed assessment is moderately relieving, but nevertheless argues that an important support for global growth is fraying around the edges. This brings particular consequences for emerging-market growth, and may even impact inflation and inequality.

A history of trade

The modern era of globalization began fitfully at the close of the Second World War, strengthened through the 1970s and 1980s, and then shifted into overdrive in the 1990s and 2000s as China and the Soviet Bloc economies began to open themselves to the world. Global trade soared over this period, sustaining a growth rate almost twice that of the economy. As a result, trade increased from just 35% of the size of GDP in the mid-1980s to more than 60% today. This globalization unleashed a torrent of demand, productive capacity and competition-driven innovation, all of which boosted the global economy to new heights.

Trade derailed

It is thus highly notable that globalization – especially globalization narrowly defined through the lens of trade – appears to be slowing. Since the start of 2011, real export growth has merely matched GDP growth, not doubled it. Trade performs better than this a whopping 90% of the time. Had exports continued their usual trajectory, there would be an additional US$1.4 trillion of annual global exports by now. So what has caused trade to fare so poorly? The answer can be broken into cyclical and structural components.

Exhibit 1: Why did trade slow?

CYCLICAL	STRUCTURAL
▪ Geopolitics	▪ Emerging-market slowdown
▪ Lingering financial crisis	▪ Competitive parity
▪ Protectionism	▪ Trade saturation
	▪ Current-account rebalancing

Source: RBC GAM

Cyclical drivers

Some candidates are cyclical in nature, meaning that while they exert negative pressures now, they should eventually relinquish their grip:

1) Geopolitics

Geopolitical tensions – of which there are many – are a possible reason for slower trade. For example, the China-Japan dispute over an obscure island chain has bled into the economic sphere, with perhaps $25 billion foregone in annual trade. New Russian sanctions may increasingly interfere with trade going forward, but they can hardly explain a trade slowdown three years in the making. In short, geopolitics matter, but they have not been a central reason for the $1.4 trillion trade gap.

2) Lingering financial crisis

Financial crises bring a great deal of undesired baggage, some of which lingers for years. For instance, as depicted in Exhibit 2, standard consequences include slower-than-normal economic growth and protectionism. Might these, in turn, explain the trade slowdown?

On the subject of economic growth, there is no question that it has been slower than usual since the initial rebound from the 2009 recession. Timing-wise, this presents itself as a plausible candidate to explain diminished trade growth. The question that remains is whether slower economic growth might have an outsized effect on trade growth. Our calculations find that in the context of the recent pace of global economic growth, real exports should be expanding at just 5% per year, rather than the norm of 6%. Of course, actual exports haven't even managed this, instead churning in the vicinity of a mere 3% annualized growth. Thus, we can say that the sluggish economic environment is responsible for a significant 30% of the trade underperformance, but nowhere near all of it.

3) Protectionism

Global economic conditions are undeniably ripe for a swell of protectionism. Indeed, whereas the world was until recently focused on breaking down trade barriers, the tide seems to have turned.

This is evident in the rise of Europe's Euroskeptic parties, in the aspirations of various separatist movements scattered around the world and in a general feeling of unrest. Although international tariffs have declined nicely over the past few decades and a handful of trade agreements have been struck in recent years, careful observation reveals a glint of protectionism. Tariffs are beginning to edge higher, and other insidious forms of protectionism are swelling.

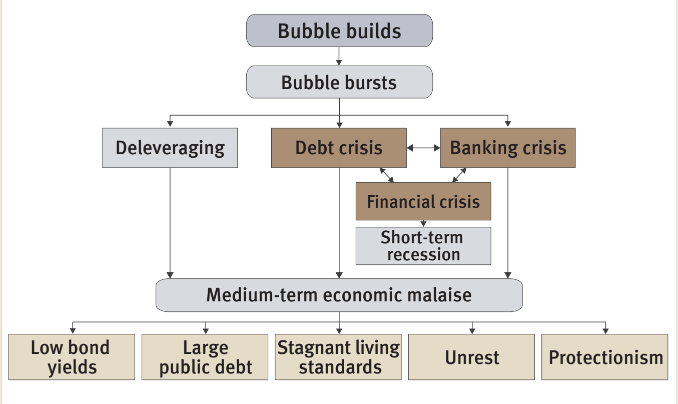
By several measures, protectionism is an impediment to trade. The challenge lies in quantifying this. One academic paper[1] finds that protectionism did indeed increase in the throes of the financial crisis, but it could explain only a small fraction of the initial trade collapse during the crisis. Of course, trade has since partially rebounded while the protectionist environment has seemingly worsened. These combine to argue that protectionism must constitute a significantly larger fraction of the remaining trade underperformance today. We estimate that protectionism accounts for around one-fifth of the global trade shortfall.

Structural drivers

1) Emerging-market slowdown

Emerging-market economic growth has slowed strikingly over the past few years. Naturally, this has had a significant effect on trade. To illustrate, China's import growth has tumbled as its demand has slowed, and export growth has also fallen. Indeed, emerging-market trade growth has decelerated more severely than among developed nations.

Exhibit 2: Crisis progression flowchart



Source: RBC GAM

But, did slower emerging markets compromise trade growth, or might it have been slower trade growth hitting emerging markets? We believe the causality runs partially in each direction, but our intuition (backed by empirical evidence) argues that the emerging-market growth-to-trade channel was indeed probably the more important one.

2) Competitive parity

Wages in many emerging-market economies – China most notably – have substantially outpaced productivity gains. In contrast, much of the developed world, including the U.S., has restrained wage growth even as productivity has risen. This has materially reduced the competitiveness gap between emerging markets and developed nations.

The growing importance of capital goods as a production input (and the freely available flow of such goods thanks to globalization) further diminishes the comparative advantages and disadvantages between nations. All of this means that countries simply don't need to trade with one another as much as they might once have.

3) Trade saturation

An admittedly unconventional way of assessing the trade quandary is by evaluating who can conceivably buy all of the additional exports each year. China has managed to grow its nominal exports by a remarkable 17% per year over the past decade. Even adjusting for global population growth and inflation, it is difficult to fathom the average world consumer continuing to want 12% more Chinese products each and every year. Could we be bumping up against some sort of natural saturation point that guides trade growth back into line with economic growth?

In China's case, its share of global exports is now almost equal to its share of global GDP. This hints that a sort of parity

[1] "Is Protectionism On The Rise During The Crisis?" by Kee, Neagu and Nicita.

has been reached, at least for the world's largest emerging-market nation.

4) Current-account rebalancing

Another unorthodox structural consideration relates to the current account. The world's current-account imbalances have shrunk nicely over the past several years, with policymakers articulating a desire to sustain that trend into the future.

One way of thinking about countries with large current-account surpluses is that they are "over-exporters," while those with big current-account deficits are "over-importers." Thus, as current accounts rebalance, some of these prior trade excesses are gradually fading.

Trade outlook

With all of this in hand, the trade outlook can be broken into short-term and medium-term perspectives.

Short-term outlook

The short-term outlook – over the next six months or so – argues for a slight improvement in trade (Exhibit 3). A combination of trade surveys and actual trade trends argue for a so-so to good trade outcome over that time horizon. A smattering of port, rail and trucking statistics offer a similarly mixed outlook.

Medium-term outlook

Based on our analysis, it appears that around half of the trade slowdown is structural and half is cyclical. Thus, we cannot expect trade growth to fully return to its prior glories, but it should nonetheless partially rebound as geopolitical issues fade, the financial crisis gradually loosens its grip and the protectionist instinct (eventually) abates.

Implications

Persistently slower trade growth can indeed be thought of as symptomatic of decelerating globalization (though not of outright declining globalization). This prospect brings several economic implications. It is likely that sustainable global economic growth will suffer by several tenths of a percentage point in the face of slower trade growth, though this is difficult to assess with precision.

Exhibit 3: Near-term export outlook is improving slightly

	EXPECTED EXPORT GROWTH	EXPORT MOMENTUM	vs. DOMESTIC ECONOMY
U.S.	So-so	Flat	Poor
Germany	Good	Good	So-so
China	Subpar	Good	So-so
Overall	**So-so**	**Good**	**So-so**

Note: Derived from export and production components of U.S. ISM Manufacturing, German IFO and China PMI. Source: Haver Analytics, RBC GAM

Any economic deceleration should be especially marked for emerging-market nations. While the dominant relationship extends from slower emerging-market growth to slower trade, it is nevertheless a two-way street. A slower trade environment is particularly relevant for highly trade-dependent emerging-market nations. Those that best evade this slowdown will be the ones that succeed in building a larger domestic consumer base.

Diminishing globalization also means that some of the downward pressure on inflation may lighten, though it is important to acknowledge that the deflationary impulse from globalization was never as great as commonly imagined due to the positive force that emerging-market economies exert on commodity prices. Thus, the upward effects on inflation should be quite slight.

Finally, the pattern of accelerating inequality could also begin to slow. Although by no means the only influence on this trend (automation, declining unionization and the rate of return on capital also play important roles), globalization has undeniably repressed developed-world wages and offshored many middle class jobs. With greater competitive parity, these pressures should ease somewhat.

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