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## The Risk of Protectionism: What Can Be Lost?

### Abstract

The increasing wave of protectionism in various corners of the world with the use of seemingly attractive but economically misleading slogans (shortening the supply chains, onshoring, reshoring, nearshoring, friendshoring, reindustrialization, ending/ correcting ‘hyper globalization’, etc.) creates a serious challenge to the global trading system and global economic development. Trade and financial transactions have also become victims of the increasing number of geopolitical conflicts and tensions, both ‘hot’ and ‘cold’.

Before it becomes too late, i.e., before the current trade tensions go too far and create the hardly reversible spiral of trade and financial wars, retaliations, etc., it is desirable to reflect on what can be lost due to protectionism. The essay analyzes four policy areas that have benefited from global economic integration since the 1980s (economic growth, poverty eradication, reduction in global economic inequalities and disinflation) and may suffer from its reversal. It also discusses potential remedies which may help stop a protectionist drift.

### 1. Introduction

The rapid global economic integration period, globalization<sup>1</sup>, started in the 1980s and gained momentum in the 1990s and early and mid-2000s. It stagnated after the global financial crisis (GFC) and never regained the previous dynamics. Worse, since the end of the 2010s, the risk of its reversal has intensified. The US-China trade conflict and geopolitical rivalry, the COVID-19 pandemic, Russia’s aggression against Ukraine, and protectionist sentiments worldwide have stayed behind this trend change. The notions of deglobalization, decoupling, economic fragmentation, and even Cold War II have frequently floated in political and economic debate.

While some of those who were skeptical of globalization, or at least of some of its forms (see, e.g., Stiglitz, 2002; Rodrik, 2011) can meet the perspective of deglobalization with satisfaction, others, including the author of this essay, worry about the potential negative socio-economic consequences of such a process. Before it becomes too late, i.e., before the current trade tensions go too far and create the hardly reversible spiral of trade and financial wars, retaliations, etc., it is desirable to reflect on what can be lost due to fragmentation of the

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<sup>1</sup> For the purpose of this essay we use Wolf (2005, p. 14) definition of economic globalization as ‘*the integration of economic activity across borders, through markets.*’ For a broader discussion of this notion see, e.g., <https://www.piie.com/microsites/globalization/what-is-globalization> .

world economy. This essay serves this purpose. It is based on a literature review and empirical research.

It starts with a historical overview of two waves of globalization – between 1870 and 1914 and a century later. (Section 2). It will be followed by an analysis of the factors that determined the rapid globalization between the 1980s and 2000s (Section 3) and the socio-economic gains attributed to globalization (Section 4). Section 5 will be devoted to the increasing protectionist pressures at the end of 2010s and early 2020s and the expected negative consequences of deglobalization/ fragmentation of the world economy. In Section 6, we discuss policy remedies that can arrest protectionist trends. Section 7 contains a summary and conclusions.

## **2. A brief history of globalization: the first and second wave**

The late 20th/ early 21st century globalization episode was not the first in contemporary economic history<sup>2</sup>. A century earlier, between 1870 and 1914, there was another period of globalization (see, e.g., Bordo et al., 1999; O'Rourke and Williamson, 2000; Morys et al., 2008; Daudin et al., 2010) underpinned by the first and second industrial revolutions, relatively liberal trade policies, the gold standard and full convertibility of major currencies and, last but not least, relative peace between major political and economic powers.

Industrial revolutions facilitated mass production, in which the economy of scale and market access (beyond national borders) played an increasing role. New technical innovations<sup>3</sup> (steam power and railways, followed by electricity and combustion engines) made transporting goods and people cheaper and safer. They also contributed to the development of new means of communication (telegraph, then telephone), which made trade and financial transactions more accessible and less expensive.

The gold standard and currency convertibility reduced transaction costs and exchange rate risk. The gold standard also eliminated the risk of inflation. On the contrary, there were periods of price decline (Meltzer and Robinson, 1989) due to a limited supply of gold, productivity gains, and business cycle fluctuations.

Finally, the absence of open conflicts between major powers<sup>4</sup> reduced security risks and the risk of a sudden regime change in trade and financial flows. Hence, it was unsurprising that WWI brutally interrupted the first wave of globalization.

The interwar period of the 1920s and 1930s was characterized by increasing trade protectionism and capital movement restrictions. The collapse of four empires in Europe and its periphery (Austro-Hungary, Germany, Russia, and Ottoman Empire) caused the appearance of several new states with new currencies and customs borders. Several European countries had problems rebuilding their fiscal and monetary equilibria in the immediate post-WWI period and returning to the convertibility of their currencies. Austria, Germany,

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<sup>2</sup> Sachs (2020) distinguishes seven *ages* of globalization, starting from the Paleolithic Age, and ending with the contemporary Digital Age. His periodization is based on technical innovation and refers not only to economic integration. This essay focuses on the role of policies and regulatory regimes in economic integration (although does not abstract from technical and technological factors) and concentrates on the last 150 years.

<sup>3</sup> For an overview of the late 19<sup>th</sup> and 20<sup>th</sup> technical innovations and their socio-economic importance – see Gordon (2016).

<sup>4</sup> The Spanish-US war in 1898, and Japanese-Russian war in 1904-1905 were exceptions. However, these were relatively short episodes of limited scale. Besides, Japan, Russia, and Spain played a peripheral role in the world economy at that time.

Hungary, Poland, and Soviet Russia experienced hyperinflations (Solimano, 2020, pp. 25-60). The Union of the Soviet Socialist Republics (USSR), created in December 1922 by the Bolshevik regime on the territory of the former Russian empire, introduced at the end of the 1920s a centralized system of command economy based on a monopoly of state ownership and a far-going autarky (Leonard, 2023). The United States chose the isolationist direction of its foreign and economic policy (Dadush, 2023).

The Great Depression, which started in the United States in September 1929 and hit the entire world economy for the first half of the 1930s, triggered a new wave of beggar-thy-neighbour policies such as competitive devaluations or rising trade barriers<sup>5</sup>. WWII further devastated the global economy and global trade. As a result, the share of global exports of goods in the world's GDP declined from 14.0% in 1913 to 4.2% in 1945 (Fouquin and Hugot, 2016; Figure 1).

The post-WWII global economic and financial architecture with the triad of international institutions (the International Monetary Fund, World Bank, and International Trade Organization) was to rebuild global economic integration and overcome interwar protectionism. However, the reintegration proceeded slowly and with many zigzags. The failure of the US Congress to ratify the Havana Charter of the International Trade Organization did not allow this organization to take off<sup>6</sup>. For almost half a century, the world trade system was regulated by a looser General Agreement of Tariffs and Trade (GATT) and its secretariat in Geneva. Only the Marrakesh Agreement in April 1994, which finalized the eighth round of multilateral trade negotiations (MTN), called the Uruguay Round, allowed the creation of the World Trade Organization (WTO) with a broad trade policy agenda. In the meantime, trade liberalization progressed incrementally by covering new policy areas and bringing more countries via subsequent rounds of MTN (see Table 1).

Initially, the GATT system involved predominantly advanced economies (AEs). Due to the decolonization process, emerging-market and developing economies (EMDEs) joined GATT in more significant numbers from the 1960s. Most former communist economies in Europe and Asia joined GATT/WTO in the 1990s, 2000s and early 2010s when they advanced their transitions to a market system.

In other policy areas, the progress in opening economies, both advanced (AEs) and emerging-market and developing ones (EMDEs), was also slow. Most of them had inconvertible or only partly convertible currencies. Although the Bretton Woods system of fixed but adjustable pegs decreased transaction costs, it proved ultimately unstable and collapsed in 1971 (Garten, 1971). As a result, the 1970s and 1980s were marked by trade tensions (for example, between the US and Japan) originating from exchange rate disputes. It was also a period of macroeconomic instability in many corners of the world.

On top of that, economic policies and systems, with a more significant role of state ownership and government regulation, chosen by several AEs, did not help economic openness. The situation was even worse in EMDEs. Many adopted the statist and autarkic development models, with high protectionist barriers and import-substitution industrialization as a reaction

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<sup>5</sup> The Smoot–Hawley Tariff Act adopted by the US Congress in June 1930 increased US import tariffs to a record-high level, and triggering a global trade war because several countries retaliated (see Mitchener et al., 2022).

<sup>6</sup> See [https://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/fact4\\_e.htm](https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact4_e.htm)

to former colonial links. Some EMDEs tried to copy the economic model of communist countries, usually with disastrous socio-economic consequences.

Since the early 1980s, as a reaction to earlier policy failures, several AEs and EMDEs have entered the path of market-oriented reforms, including a more significant trade and financial openness. It allowed the acceleration of MTN, especially the Uruguay Round, and progress in global economic integration. Far-going economic reforms in large EMDEs such as China and India, the former Soviet Union (Dabrowski, 2023), and Central and Eastern Europe boosted global trade, investment and financial flows.

As a result of the above policy changes, global trade in goods and services to the world's GDP ratio grew rapidly between 1980 and 2008 (Figure 2). This expansion was driven, among others, by the subsequent rounds of MTN (in particular, the Uruguay round), the creation of the WTO, and China's accession to this organization in 2001, liberalization of current account transactions and other market-oriented reforms in several EMDEs. Innovations in transport, communication, logistics, energy, miniaturization of various devices, etc., also decreased trade costs (Figure 3).

A similar trend concerned foreign direct investment (FDI) and other financial flows (Figure 4). It was driven by the liberalization of capital accounts (Figure 5), financial sector reforms, privatization and deregulation of banks, non-banking financial institutions, and non-financial corporations with the participation of foreign capital, legal reforms, concluding bilateral and multilateral investment-protection treaties, progress in information and communication technologies (ICTs) and their application in financial transactions, and financial innovations (facilitated, in turn, by a combination of legal innovations and new ICT tools). All these factors have eliminated institutional, legal, and technical barriers to unrestricted capital movement, especially private financial flows, across the globe, substantially reduced transaction costs, and helped to integrate national financial markets into a single global market.

Capital accounts liberalization started in the 1980s in AEs and a decade later – in EMDEs (Figure 5). Substantial capital flows began with a decade-long time lag – in the 1990s in AEs and the 2000s in EMDEs<sup>7</sup> (Figure 4). The culmination of nominal global flows came in the 2000s. Smaller but still substantial capital flows characterized the 2010s. It resulted from disruption in financial intermediation, recession (especially in AEs), and higher uncertainty caused by the GFC. In addition, the new post-crisis macro- and micro-prudential regulations increased the costs of financial intermediation and investment financing (Dabrowski, 2021).

Figure 4 also shows changes in the direction of capital flows. EMDEs were net direct investment recipients during the analyzed period, while AEs were net exporters of this investment in most recorded years. Net portfolio flows seemed to play a less significant role in EMDEs, while they were more critical in AEs. Interestingly, these flows changed direction: since 2014, AEs have become a net exporter of portfolio investment. Perhaps it was a result of record-low interest rates in most AEs.

There have been significant differences between the two waves of globalization. The depth of the first wave was smaller than the second one. The share of exports of goods to GDP in 1913 (the peak year of the first wave) was approximately half of that in 2008 (the peak year of the

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<sup>7</sup> The data for EMDEs is available from 1997 only.

second wave). In the case of financial flows, the discrepancy was even more significant (Obstfeld and Taylor, 2004, p. 55). The following factors can explain the difference:

- (i) Less developed technical infrastructure and higher transportation and communication costs during the first wave (Figure 3). It was essential for financial transactions, where the telegraph was the only means of rapid information transmission and conducting financial transactions and financial market arbitrage at the end of the 19th and early 20th centuries. As a result, the spectre of financial market products traded internationally was smaller compared to the contemporary era.
- (ii) Less liberal trade regimes during the first wave: import tariffs were, on average, higher before WWI than in the 2000s and 2010s (Estevadeordal, 1997). In particular, it was the case of the United States, Russia, Argentina, Canada, Portugal, Spain, Norway and Finland. Tariffs were lower in the United Kingdom, France, and Switzerland and close to zero – in the Netherlands. There were also intra-imperial preferential trade regimes (in the British and French empires). On the other hand, non-tariff barriers, such as sanitary, phytosanitary, and technical standards, played a more limited role.
- (iii) Geographical coverage: the pre-WWI globalization was limited to Western Europe and the United States. Most of today's EMDEs remained in colonial dependence, and they benefited from economic integration only marginally and often in a distorted form.

### **3. Gains from globalization 1980-2020**

To illustrate the economic and social benefits of global economic integration for the world economy since the 1980s, we have chosen four areas: global economic growth, poverty eradication, global income inequalities, and disinflation.

#### **3.1 Global economic growth**

In the 1990s and 2000s (until the global financial crisis in 2008-2009), i.e., the period of rapid liberalization of trade and financial flows, global economic growth accelerated (Figure 6), mainly in EMDEs, particularly in the so-called Emerging and Developing Asia, using the IMF regional terminology (Figure 7). Sub-Saharan Africa, the Middle East and North Africa, and Latin America and the Caribbean regions benefited less due to many unresolved conflicts and domestic institutional and policy barriers.

AEs grew, on average, at a slower pace. However, they also benefited from globalization. In particular, it allowed for mitigating the forthcoming demographic barrier, that is, shrinking the working-age population and population ageing. Global economic integration also helped AEs build global value chains (GVCs), benefit from economies of scale, and develop global financial centres on their territories.

After the GFC, the pace of global growth gradually decelerated, partly due to the direct consequences of the crisis but also due to stagnation in global trade liberalization and emerging protectionist barriers, especially at the end of the 2010s and the early 2020s (see Section 4). Nevertheless, EMDEs continued to grow faster than AEs, diminishing the income-per-capita gap between AEs and EMDEs built up over most of the 19<sup>th</sup> and 20<sup>th</sup> centuries.

### **3.2 Eradicating poverty**

Rapid growth in EMDEs helped eradicate extreme poverty, as measured by the poverty headcount ratio of \$2.15 daily at the 2017 PPP (Table 2). Like growth trends, the most spectacular poverty reduction has been recorded in the East Asia and Pacific, and South Asia regions.

### **3.3 Diminishing global income inequalities**

Rapid economic growth in EMDEs, particularly in China, India, and other large Asian economies, also contributed to the substantial reduction in global income inequalities, i.e., inequalities among world citizens (Figures 8 and 9). This reduction was driven by decreasing income-per-capita differences between countries (Darvas, 2018), partly reversing the opposite trend dominating most of the 19th and 20th centuries (Milanovic, 2020). On the other hand, structural changes in some AEs, especially in the United States, in the absence of active domestic income redistribution policies, have contributed to increasing domestic income inequalities and, therefore, to the anti-globalization backlash. Interestingly, the diminishing trend in global income inequalities has continued in the period of weaker global growth (in the 2010s and early 2020s) despite various adverse shocks such as GFC or COVID-19 pandemics (Darvas, 2024).

### **3.4 Disinflation**

While inflation in individual currency areas is determined, in the first instance, by their monetary and fiscal policies, global trade, financial and, to a lesser degree, migration flows can contribute to the so-called supply shocks, either anti- or pro-inflationary. A rapid liberalization in trade flows in the 1990s and early 2000s helped AEs' disinflation, pushing the prices of imported goods down and discouraging increases in domestic wage levels (Goodhart and Pradhan, 2020). On the contrary, the recent protectionist trend has overlapped with the effects of monetary and fiscal policies in AEs that were too expansive in the 2010s and early 2020s (Dabrowski, 2021), magnifying a global inflation shock.

## **4. Protectionist backlash and associated risks to global socio-economic development**

### **4.1 Change in integration trend**

From 2008, global trade and financial integration slowed and was even partly reversed (Figures 1-2 and 4). This trend change is often attributed to the effect of GFC (see James, 2018). While it may be true in the case of financial flows (implosion of financial markets caused by the GFC, followed by tighter micro- and macro-financial regulations, and a partial return to some forms of capital controls in EMDEs – see Figure 5), one can look at other explanations in the case of trade flows. The implementation of trade liberalization measures envisaged by the GATT Uruguay round and the Marrakesh agreement was completed around the mid-2000s. The new WTO negotiation, the so-called Doha Development Round, failed (Bhagwati, 2012), so no new global trade liberalization impulses existed. The proliferation of regional and bilateral preferential trade agreements (PTAs), especially in Europe and Asia-

Pacific, somewhat mitigated the stagnation trend but could not fully compensate for the lack of progress in global trade negotiations<sup>8</sup>.

The end of the 2010s and early 2020s brought an increasing wave of protectionism (Figure 10) in various corners of the world underpinned by national political developments in individual countries, the COVID-19 pandemic, and the proliferation of geopolitical rivalries and conflicts, both ‘hot’ (for example, the war in Ukraine) and ‘cold’. Government financial support to exporters and import-substituting producers has played a leading role in this protectionist race (Fritz and Evenett, 2021; Evenett, 2023). It has had various forms depending on specific sector/ industry, for example, government grants, tax exemptions, borrowing on preferential terms, loan guarantees, use of subsidized energy, capital injections and equity stakes, including bailouts, etc. (IMF et al., 2022; Evenett, 2023). Although subsidies are the subject of two WTO agreements – Agreement on Subsidies and Countervailing Measures and Agreement on Agriculture – several regulatory loopholes allow circumventing them in practice.

#### **4.2 The rise of China and the US-China trade conflict**

Since the early 1980s, China has recorded rapid economic growth due to domestic economic reforms (including economic openness) and the benefits of globalization. As a result, China restored its dominant economic power status, which it enjoyed until the early 19<sup>th</sup> century. China’s share of the world GDP, calculated in terms of purchasing power parity (PPP), increased from 2.6% in 1980 to 18.4% in 2021 (IMF, 2023, Table A, p. 99). China has become a leading manufacturer, producer, and exporter, competing successfully with other EMDEs and AEs (Jean et al., 2023). However, the market-oriented transition in China has not been complete, and the role of the government and the Chinese Communist Party in economic management has remained significant (European Commission, 2017). Chinese producers and exporters have often enjoyed government support that is incompatible with the WTO rules. While AEs have benefited from cheaper Chinese imports (see, e.g., Subsection 3.4 and Goodhart and Pradhan, 2020), their expansion has also contributed to the protectionist backlash, in the first instance, in the United States.

The US-China trade and economic tensions, which grew gradually during the 2000s and 2010s, broke out in the form of open conflict in 2018. As a result, the average US trade-weighted import tariffs for Chinese exports increased from 3.1% in January 2018 to 21.0% in September 2019 (Figure 11). In February 2020, due to the Phase One Agreement between the United States and China, they decreased to 19.3% and have stayed at this level since then (Bown, 2023a). Chinese trade-weighted import tariffs for US exports increased from 8.0% in January 2018 to 21.8% in September 2019. From February 2020, they amounted to 21.3%. At the same time, they gradually decreased for the imports from the rest of the world from 8% in January 2018 to 6.5% in January 2023.

The protectionist drift in the US trade policy under the Trump administration did not affect only China (Bown and Kolb, 2023). The average US trade-weighted import tariffs for exports from the rest of the world increased from 2.2% in January 2018 to 3.0% in October 2019 (Figure 11).

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<sup>8</sup> PTAs have both trade creation and trade diversion effect. If the latter is stronger than former the net effect is negative. However, even if the net effect is positive, PTA are the second-best solution as compared to global trade liberalization. Bhagwati (2008) calls them ‘termites in the trading system’.

In January 2023, the higher tariffs covered 66.4% of US imports from China and 58.3% of China's imports from the US (Bown, 2023a).

At the beginning of the US-China trade war, the EU kept itself far from this conflict. On December 20, 2020, it concluded in principle a Comprehensive Agreement on Investment with China, which envisaged several liberalization measures on both sides (Dadush and Sapir, 2021). However, this agreement has not been finalized since then. On the other hand, as of February 2, 2024, 41 out of 52 ongoing EU trade defense investigations related to imports from China.<sup>9</sup>

### 4.3 A new protectionist rhetoric

'Traditional' protectionist arguments referred, among others, to the necessity of protecting infant industries, jobs, and welfare systems and supporting import-substitution programs, consumer, health, and environmental protection. The new protectionism employs seemingly attractive but economically misleading slogans such as shortening the supply chains, onshoring, reshoring, nearshoring, friendshoring, reindustrialization<sup>10</sup>, ending/ correcting 'hyper globalization,' national security considerations, implementation of a 'green' agenda, etc.

The COVID-19 pandemic and policy responses to this calamity have provoked some of these arguments<sup>11</sup>. Lockdown measures initially aimed to stop the spread of the pandemic. They sought to limit the infection contagion when this goal was not met. They concentrated on national borders, where administrative controls could be easier to execute than those inside the country (although several countries have introduced formal bans on the internal movement of people). There was little international cooperation in adopting lockdown policies, even inside such a deeply integrated bloc as the European Union (EU) and many beggar-thy-neighbor measures. As a result, the pandemic caused a far-going disruption in global supply chains (Lery Moffat and Poitiers, 2024), that is, in trade, transportation, and logistical links, leading to physical shortages in many goods and services, for example, semiconductors (Kaur, 2021) and containers (Teodoro and Garratt, 2023).

The wrong macroeconomic diagnosis of the crisis character (destruction of aggregate demand, like during the GFC) led to incorrect macroeconomic policy responses – launching massive monetary and fiscal stimuli (Dabrowski, 2021). They caused global inflationary pressures in 2021-2023 and deepened disequilibria in individual product and service markets. Structural changes in demand have also caused disequilibria. For example, progress in digitalizing many services (accelerated by lockdowns) increased the demand for semiconductors and various software products.

Trade and transportation disruptions and physical shortages caused by the COVID-19 pandemic and lockdown measures stayed behind the numerous calls for shortening supply chains, reshoring, and nearshoring. They abstracted from the fact that pandemic-related disruptions also affected local markets and supply chains. They also disregarded the causes of supply shortages. Fortunately, some of these calls abated after lockdown measures were

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<sup>9</sup> See <https://tron.trade.ec.europa.eu/investigations/ongoing>

<sup>10</sup> See, e.g., <https://webapi2016.eesc.europa.eu/v1/documents/eesc-2013-06859-00-00-ac-tra-en.doc/content>

<sup>11</sup> This essay does not have ambitious to offer a comprehensive assessment of policy responses to the COVID-19 pandemic and speculate whether there were other, better responses. The focus is only on the impact of adopted policies on protectionist sentiments and specific arguments used in the policy debate.



terminated, and the market mechanism helped to restore/ adapt the broken GVCs quickly. On the other hand, tighter monetary policies helped to rebuild the equilibrium between demand and supply.

However, there have been other arguments (ecological, geopolitical) in favor of reshoring and nearshoring, which have not disappeared. Shortening supply chains, which can reduce CO2 emissions and prevent climate change, has been one of them. It can be the correct argument if nearshoring or reshoring will not increase cumulative CO2 emissions due to a less efficient production and service chain. The universal carbon tax (see Section 5) would be the best instrument to stimulate the optimal localization decisions of economic agents rather than protectionist trade policy measures.

Geopolitical considerations are more challenging to internalize into autonomous market choices of economic agents. They are subject to government decisions, and many of them affect trade and investment policies. However, governments must understand the socio-economic costs of such decisions. Geopolitical arguments cannot be overplayed, and trade and financial policy instruments cannot be overused for foreign and security policy purposes (see Subsection 4.4).

#### **4.4 Geopolitical tensions and economic openness**

In the 1990s, after the collapse of the USSR, the dissolution of the Warsaw Pact, and the end of the Cold War, several countries could enjoy the peace dividend in the form of lower military spending, fewer security concerns in trading military or dual-use products and technologies, and academic and technical cooperations, more freedom in movement of people, and better geopolitical atmosphere in global and regional economic cooperation<sup>12</sup>. However, it was a relatively short episode in world history.

The terrorist attack against the US on September 11, 2001, ended the atmosphere of a relatively peaceful global cooperation. Military interventions in Afghanistan and Iraq caused the necessity of higher military spending, at least in the US. Various non-military security measures in the US and other countries affected the movement of people (especially for citizens of countries considered potential terrorist hubs) and financial transfers (tighter control of trans-border transfers to prevent financing terrorism). Fortunately, trade flows and FDI remained unaffected.

The end of the 2010s and early 2020s have brought further deterioration in international dimensions. Among various examples of increasing geopolitical tensions and open conflicts, two of them deserve additional comment.

The first concerns the increasing geopolitical tensions between the US and China beyond the trade and economic conflict discussed in Subsection 4.2. They have been caused by the rapidly increasing military potential of China, its more aggressive foreign and security policies, increasing assertiveness against its Asian neighbors, many of which are the US allies and enjoy the US security guarantees, autocratic drift in China's domestic policies, and the US fear of losing status as the single global superpower. The US protectionist measures against imports from China analyzed in Subsection 4.2 were partly motivated by geopolitical

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<sup>12</sup> The 1990s were not free from violent conflicts, for example, in the former Yugoslavia, and many corners of Africa. However, they had isolated character, involved countries with negligible shares of global output and did not impact negatively international economic cooperation and governance.

and security considerations. However, national security considerations thoroughly explained the export control measures introduced by the US Department of Commerce in October 2022 aimed at curbing exports of advanced chips and other cutting-edge technologies to China (Nellis et al. 2022).

The US have pushed their allies in Europe and Asia-Pacific to create a common front against China, the partly successful pressure. China has also given increasing attention to national security considerations in its economic policy decisions (Choyleva, 2024; Leonard, 2024).

Fortunately, tensions between the US (and their allies) and China have not reached the stage of open confrontation, although they have an increasingly negative impact on economic relations. However, given the economic and trade potential of China and the US (and other AEs actually or potentially involved in this conflict), negative consequences for the global economy can be far-going (see Subsection 4.5).

The second severe disruption to the post-Cold War global political and economic order has been caused by the increasingly aggressive actions of Russia in its neighborhood, culminating with its full-scale military aggression against Ukraine in February 2022. The initial response of the US, EU, UK, and their allies concentrated on scaling up economic and financial sanctions initiated after the annexation of Crimea by Russia in 2014 (Dabrowski and Avdasheva, 2023). The Western military aid to Ukraine came later. Although Russia's share in the global GDP and global trade is much lower compared to China<sup>13</sup>, Russia's role as a large supplier of energy resources and its countermeasures against sanctions issuers (Dabrowski and Avdasheva, 2023) caused severe economic turbulences beyond the direct zone of conflict in 2022-2023 (see, e.g., Arndt et al., 2023; McWilliams et al., 2024).

The rise of global geopolitical tensions is the argument for the subordination of economic policies to security considerations. It concerns higher military and security-related expenditures, development of the defense industry, trade and investment policies, cross-border scientific and technological cooperation, financial flows, migration, etc. The vagueness of security arguments, i.e., what are the real security risks, which instruments can be used to minimize them, what are their potential benefits (in achieving security goals) vs their economic, social, and political costs (direct and indirect) make the debate difficult, and sometimes emotional. One can suspect that security arguments are sometimes used to mask 'traditional' protectionist demands.

Conceptually, measures motivated by security considerations can be divided into preventive (aimed to avoid/minimize ex-ante risks) and reactive (penalizing unacceptable actions). However, an ex-ante cost-benefit analysis is required in both cases. Ex-post assessment of the effectiveness of sanction packages imposed in less or more distant past against geopolitical adversaries in achieving intended goals vs costs for sanction issuers and third parties (see Peksen, 2019, for the literature overview) can serve as a good starting point for ex-ante analysis of any new sanction measures.

For example, the experience of far-going sanctions against Russia in 2022-2023 seems disappointing. They failed to stop the aggression against Ukraine and reduce, in a meaningful way, Russia's economic and military potential to continue the war. They were frequently

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<sup>13</sup> In 2022, China accounted for 18.4% of the world GDP in PPP terms, while Russia – for 2.9%. China's share in the world exports of goods and services amounted to 11.9%, which Russia's share – to 1.8% (IMF, 2023, Table A, p. 99).

circumvented (e.g., Hilgenstock et al., 2023; Bilousova et al., 2024; Astrov et al., 2023). They also caused collateral damage to European economies by increasing energy prices in 2022.

The UN sanctions against Iran between 2006 and 2016 were more effective in achieving their goal, that is, pushing Iran to limit its military spending (Dizaji and Farzanegan, 2021) and freeze its nuclear program. However, the Iranian economy was smaller and less self-sufficient than the Russian one, and the sanctions against Iran had a global character. In Russia's case, several EMDEs (approximately half of the global GDP) have not joined sanctions introduced by the US, EU, UK, and their allies.

The experience with sanctions against Russia should serve as a lesson to be careful when weaponizing trade and financial instruments in geopolitical rivalry with China. This much bigger economy is more deeply rooted in the global trade and investment relations network, so attempts at its sanctioning can fail to achieve geopolitical goals and cause collateral damage to the world economy (see Cerdeiro et al., 2023).

#### **4.5 What can be lost?**

Failure to stop protectionist trends can lead to erosion of the gains from globalization and undermine growth and macroeconomic stability perspectives in both AEs and EMDEs.

Economic growth can further slow down, given that protectionism is not the only headwind a global economy faces. The declining working-age population and population ageing are another challenge, particularly in Europe and East Asia. AEs may become the main losers, but several EMDEs will also suffer. The latecomers of globalization (Africa and part of the Middle East) can lose a chance of catching up with the rest of the world.

Materialization of such a scenario does not necessarily require a global trade conflict like that in the early 1930s. It is enough to continue the fragmentation of the world trade system along the lines of geopolitical blocs, that is, friendshoring (see Figure 12). Even the countries which could expect to benefit from the US-China trade tensions, for example, Vietnam and other countries of Southeast Asia, would be eventual losers because the general equilibrium effect (slower growth of a global economy) might outweigh trade diversion in their favor (Cerdeiro et al., 2023).

Innovation and potential productivity growth may be other losers. They depend primarily on the free international movement of technologies, capital, investment, and people and unrestricted cooperation between universities and other research centers. Unfortunately, this movement has already been restricted, especially (but not only) between the US and China (Poitiers and Sekut, 2024).

Unlike in the 19<sup>th</sup> and 20<sup>th</sup> centuries, scientific and technical progress is no longer generated predominantly in Western Europe and North America. Research and industrial centers in some EMDEs, especially in China, play an increasing role in new patents, high-quality academic publications (Poitiers and Sekut, 2024), and frontier technology research. Hence, the bifurcation of research and innovation efforts will be costly and cause slower productivity growth.

Trade, investment, technology protectionism, and the slower global growth they cause will not help mitigate climate change. The mounting trade tensions around China's dominance in

producing solar panels (Allison, 2023), electric vehicles (Webster, 2024), and high-capacity batteries (Poitiers and Sekut, 2024) are good examples. They represent a clear case of the conflict between the global decarbonization agenda (which requires a mass and inexpensive production of devices and materials crucial for completing a green agenda) and industrial policy goals and geopolitical concerns in some AEs, focusing on self-sufficiency in sectors considered as strategically important.

Slower growth, especially in EMDEs, caused by protectionist drift will not help further eradicate poverty and reduce global income inequalities (between citizens of the world), contributing to even stronger cross-border migration pressures. Unlikely, it can help reduce in-country inequalities.

Fighting the post-pandemic wave of inflation will take longer and involve higher output losses because protectionist measures have already generated a pro-inflationary supply-side shock<sup>14</sup>. Looking ahead, continued trade protectionism or even the absence of further trade liberalization measures will increase the macroeconomic and social costs of price-stability-oriented monetary policies.

Finally, the fragmentation of global trade and financial systems can undermine geopolitical stability. One can observe a vicious circle: the current conflicts contribute to protectionism and economic disintegration, but the latter can trigger new conflicts. Even if trade and financial integration are not perfect safeguards against political and military conflicts (as history teaches us), they increase the costs of such conflicts and, therefore, can serve as a conflict deterrent to a certain degree (Lee and Pyun, 2009). Furthermore, slower poverty eradication in EMDEs and slower progress in mitigating climate changes (due to global economic fragmentation) can also trigger new domestic and international violent conflicts.

## 5. Remedies

It is not too late to stop the protectionist drift and avoid the associated losses described in subsection 4.5. There are at least three avenues to achieve this goal: (i) the WTO institutional reform and continuation of the multilateral negotiation aimed at updating the existing global trade agreements and concluding new ones; (ii) further developments of regional and inter-regional PTAs; (iii) domestic policy reforms, especially in the case of large trade players. These three avenues are at least interlinked.

The reform of the WTO and negotiation of a new set of global trade agreements would be the first best. It could arrest the erosion of the worldwide trade rules established during the subsequent rounds of GATT and WTO negotiations. It would also save the WTO as a meaningful international institution. In an optimistic scenario, it could provide a new impetus to global trade liberalization.

The WTO reform has been discussed from various angles, at least since the start of the unsuccessful Doha Round (see, e.g., Soobramanien et al., 2019). Since 2017, the most urgent task has been to reform the WTO Appellate Body, which was disabled by the US decision to stop filling vacancies<sup>15</sup>. The inability of the Appellate Body to perform its statutory role

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<sup>14</sup> Hufbauer et al. (2022) argued that a trade liberalization package amounting to 2 percentage point tariff-equivalent reduction (mainly reversal of the import tariff increases of the Trump's administration) could offer a one-off reduction of the US inflation by ca. 1.3 percentage points.

<sup>15</sup> The US objections were articulated, among others, in US Trade Representative (2020).

paralyzes the entire WTO system of dispute settlements<sup>16</sup>, the primary enforcement mechanism in the hands of these institutions.

The updated international agreements are urgently needed in trade in services (given the increasing share of services in GDP) and harmonization of green policies (to avoid a protectionist backlash motivated by a green agenda). Given the unanimity requirement in the WTO decisions, challenging to achieve, the plurilateral agreements of countries interested in regulating trade and investment relations in a particular sector or in solving a specific problem (a coalition of willing) seem to be the most pragmatic negotiation strategy (Schmucker and Mildner, 2023). To the greatest extent possible, such agreements should consider the interests of a maximum number of WTO members, including less developed countries, not only those participating in the negotiation. They would remain open to all potential future signatories.

Parallel to the WTO reform and continuing global trade negotiations, efforts should be put into further developing bilateral and multilateral PTAs and deepening existing ones. PTAs are the second-best solutions as compared to global trade liberalization. As mentioned in Subsection 4.1, they involve both trade-creation and trade-diversion effects. However, if they have sufficiently broad (regional or inter-regional) coverage, the first effect may prevail over the second one. They may reinforce trade-gravity effects from geographic proximity if they involve close neighbors. In addition, they also often serve other goals beyond trade and investment relations, such as the stage to deeper regional economic and political integration, support to economically less-developed partners, etc. They are a form of friendshoring (see Subsection 4.5).

Unfortunately, the pace of regional/ interregional trade and investment integration based on PTAs has slowed since the end of 2010s due to the same protectionist drift that paralyzed global trade negotiations and the WTO reform. In January 2017, the Trump administration in the US withdrew from the Trans-Pacific Partnership (TPP) signed a year earlier. Although 11 other signatories from North and South America, East and South East Asia and the Pacific region decided to continue this deal under the new name (the Comprehensive and Progressive Agreement for Trans-Pacific Partnership), its trade and economic significance and impact are smaller than the original TPP due to the absence of the most significant partner (the US). The Trump administration also suspended negotiations on another mega-deal – the Transatlantic Trade and Investment Partnership (TTIP) with the EU.

The EU has tried to continue its relatively open trade policy by signing several PTAs with partners in various continents. However, in the early 2020s, its trade liberalization effort has also stalled. The EU-Australia free trade negotiation was suspended in 2023 due to its reservation to open part of the Single European Market to import Australian agriculture products (Sapir, 2023). The EU agriculture protectionism can also be blamed as one of the problems in finalizing the EU-Mercosur Trade Agreement, despite reaching a political agreement between both sides in June 2019 (Dadush and Baltensperger, 2019; Demarais, 2024).

The African Continental Free Trade Agreement (AfCFTA) (Echandi et al., 2022) and the Regional Comprehensive Economic Partnership (in the Asia-Pacific region)<sup>17</sup> are two large

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<sup>16</sup> See [https://www.wto.org/english/thewto\\_e/minist\\_e/mc12\\_e/briefing\\_notes\\_e/bfwtoreform\\_e.htm](https://www.wto.org/english/thewto_e/minist_e/mc12_e/briefing_notes_e/bfwtoreform_e.htm)

<sup>17</sup> See <https://www.dfat.gov.au/trade/agreements/in-force/rcep>

regional PTAs concluded at the end of the 2010s/ early 2020s. Even if both are not very deep in their economic contents (focusing primarily on trade in goods), they can help integrate large regional markets and boost economic growth. It is crucial for Africa; however, many other accompanying trade facilitation measures are needed to grasp the full potential benefits of AfCFTA (Echandi et al., 2022; Fofack, 2024). The resolution of several violent conflicts is another condition of successful AfCFTA implementation.

The large regional PTAs could create a bridge towards a more straightforward conclusion of global deals under the auspices of the WTO. In the first instance, it would depend on the political readiness of major parties to go in this direction (which is lacking at the beginning of 2024). However, there are also other, more ‘technical’ obstacles. First, the existing network of PTAs engages WTO members unequally. Several large EMDEs, such as Bangladesh, India, Nigeria, Pakistan, Russia, and South Africa, participate only marginally in this system. Second, the existing PTAs are incompatible, so finding a common agenda and interest between their participants would be difficult. Third, the unilateral trade preferences granted to developing countries under the Generalized System of Preferences and similar schemes may discourage beneficiary countries from engaging in trade negotiations, which require their trade concessions.

The third avenue, that is, market-oriented and macroeconomic stability-enhancing reforms in individual countries, can facilitate further global and regional economic integration and change domestic political economy balances in favor of trade and investment liberalization, as it happened in the 1980s and 1990s in several corners of the world (see Section 2). Usually, the focus is on large EMDE players such as China, India, Argentina, Brazil, and South Africa. In particular, China should reconsider its industrial policy, given its role in the world manufacturing trade. Reducing state aid, increasing openness to foreign investment, better protecting property rights, including intellectual property rights, and eliminating other distortive policies could address at least some of the concerns of its trading and investment partners.

AEs also have an extensive agenda of trade-friendly domestic reforms. They concern not only the most obvious suspect, i.e., agriculture support and its protection against external competition (the case of the US, EU, Japan, Switzerland, Norway, Iceland, South Korea, and the UK<sup>18</sup> -see IMF et al., 2022). AEs must also mitigate their appetites to conduct industrial policies (see Bown, 2023b). In particular, AEs should abandon dreams of reindustrialization, which are inconsistent with the level of their socio-economic development and demographic trends. They also should consider the fiscal costs of industrial policies (especially when they require subsidies) in the continuous fiscal imbalances and high public debts in most AEs. Similarly, realistic cost-benefit analyses regarding proposals to use trade and investment measures against actual or potential geopolitical adversaries are needed.

## **6. Summary and conclusions**

After four decades of the second wave of globalization, the world economy and global economic order are at a crossroads. The mounting protectionist pressures in various corners of the world put the perspective of future economic growth and further reduction of extreme poverty and global income inequality (between citizens of the world) under question. These

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<sup>18</sup> Among EMDEs, India and Kazakhstan account for the largest budgetary support to agriculture calculated in % of gross farm receipts (IMF et al., 2022).

are not temporary frictions caused by unexpected shocks such as GFC, the COVID-19 pandemic or Russian aggression against Ukraine. Unfortunately, they look like a sustainable trend underpinned by the rising wave of populism, nationalism and geopolitical rivalry. While geopolitical tensions and security concerns serve as a convenient argument for protectionism, the latter may trigger new tensions or magnify the existing ones.

Given the benefits of global trade and financial flows and the degree of global economic interdependence, the scenario of a far-going deglobalization/ fragmentation of the sort experienced in the 1930s looks rather unlikely soon (unless the worldwide military conflict happens). Instead, economic integration within geopolitical alliances and blocks (friend-shoring) seems more probable. Such a scenario will involve substantial welfare losses due to trade diversion and general equilibrium effects (Cerdeiro et al., 2023). Friendshoring may also not be a good option for all global trade participants due to their geographic locations or unwillingness to take sides in geopolitical confrontations. It can also lead to higher trade concentration (Seong et al., 2024). Furthermore, history teaches us that geopolitical alliances are not always stable. Therefore, trade and investment choices based on geopolitical considerations may suffer from additional volatility.

The degree of economic and social losses caused by the fragmentation along geopolitical frontiers will depend on how aggressive a friend-shoring will be against the existing global trade order. One possibility is a proliferation of PTAs (motivated by geopolitical considerations) within the current WTO regime, as observed since the beginning of the 21<sup>st</sup> century. Another would be dismantling the existing global trade and investment order and institutions and replacing them with regional or bilateral trade deals. The second scenario would be economically more damaging than the first one.

There is still time to stop the protectionist drift, reform the WTO and reinforce the existing global economic, trade, and financial order. However, concessions must be made from all sides of international trade disputes. Most countries should return to the path of domestic market-oriented reforms, which provided them and the entire world economy with unquestionable economic benefits in the 1980s, 1990s, and early 2000s and facilitated global trade and financial liberalization.

AEs should reduce their financial support to the agriculture sector and increase the openness of their markets for agricultural goods and labor-intensive services from EMDEs. Due to their economic structures, both are important for developing EMDEs' export capacities. AEs should also abandon reindustrialization dreams and reject the temptations to excessively weaponize trade, investment, and financial policies against their geopolitical adversaries. A rigorous cost-benefit analysis is required each time, as in the case of other policy measures. It is also important to acknowledge that global threats such as global warming or pandemics can be best tackled by well-coordinated global actions based on open markets rather than inward-oriented industrial policies or other beggar-thy-neighbor measures.

EMDEs have an even larger agenda of reforms to reduce further tariff and non-tariff barriers to trade barriers to foreign investment, abandon import-substitution strategies, improve the rule of law, protect property rights, and strengthen their institutions and governance structures. They lack the resources to subsidize exports, import substitutions, energy prices, etc.

Trade-friendly domestic reforms and concessions in trade negotiations are not easy for obvious political-economy reasons. It takes time to see the benefits of reform, and they are dispersed among broad groups of society. At the same time, costs/sacrifices must be borne upfront by narrow groups of special interests, usually well-organized. In the ICT revolution era, when the time horizon of political decisions has shortened dramatically, it is more challenging to build a consensus around economic reforms and trade liberalization decisions than it was a few decades earlier. Nevertheless, such a political effort is needed to avoid a slippery slope towards decomposition and fragmentation of the global economy with heavy economic and social losses.

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**Table 1: GATT trade rounds, 1947-1994**

<b>Year</b>	<b>Place/ name</b>	<b>Subjects covered</b>	<b>Countries</b>
1947	Geneva	Tariffs	23
1949	Annecy	Tariffs	13
1951	Torquay	Tariffs	38
1956	Geneva	Tariffs	26
1960-1961	Geneva Dillon Round	Tariffs	26
1964-1967	Geneva Kennedy Round	Tariffs and anti-dumping measures	62
1973-1979	Geneva Tokyo Round	Tariffs, non-tariff measures, “framework” agreements	102
1986-1994	Geneva Uruguay Round	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO, etc	123

Source: [https://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/fact4\\_e.htm](https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact4_e.htm)

**Figure 1:**

## Value of exported goods as a share of GDP

Total value of merchandise exports divided by gross domestic product, expressed as a percentage.



Data source: Fouquin and Hugot (CEPII 2016)

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**Figure 2: World economy: trade in goods and services as % of GDP, 1970 - 2021**

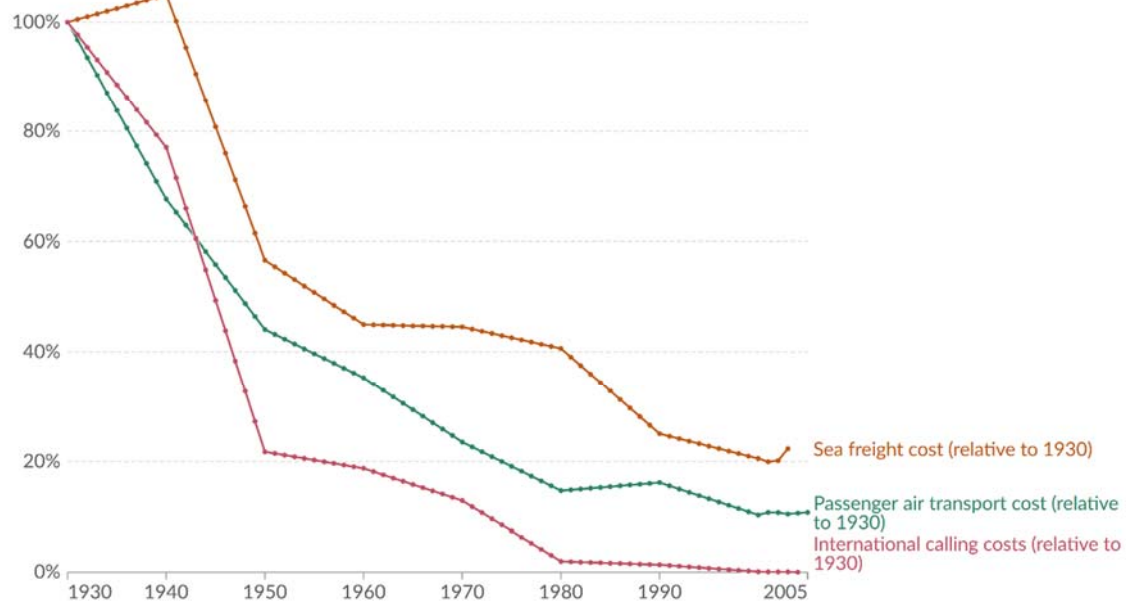


Source: <https://data.worldbank.org/indicator/NE.TRD.GNFS.ZS>; extracted on September 15, 2023

**Figure 3**

### The decline of transport and communication costs relative to 1930

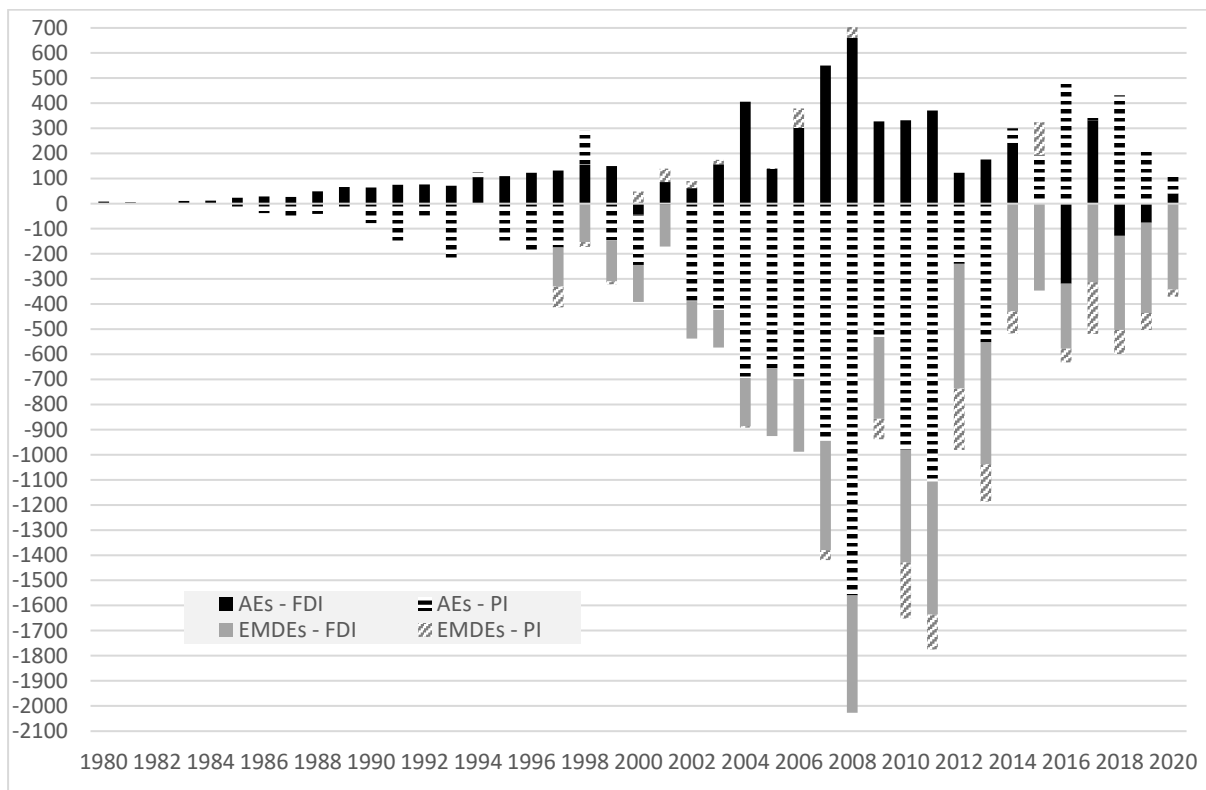
Sea freight corresponds to average international freight charges per tonne. Passenger air transport corresponds to average airline revenue per passenger mile until 2000 spliced to US import air passenger fares afterwards. International calls correspond to cost of a three-minute call from New York to London.



Data source: Transaction Costs - OECD Economic Outlook (2007)

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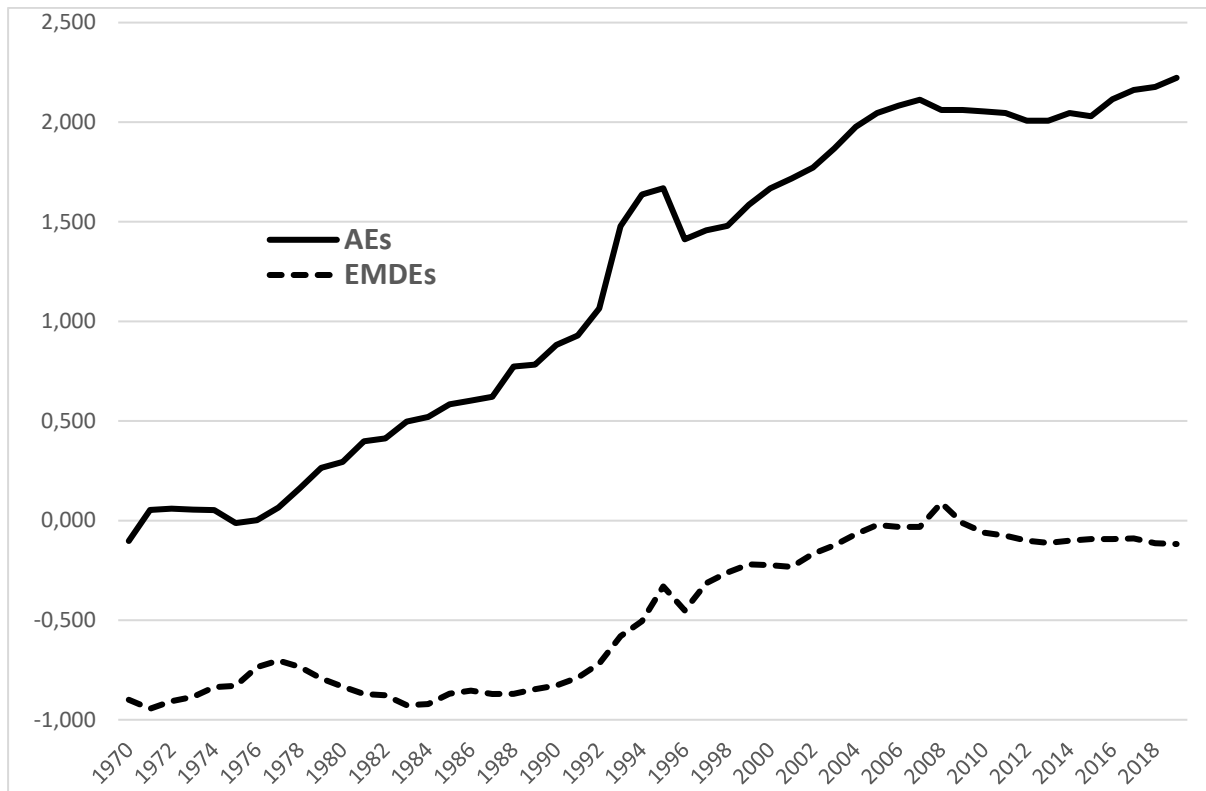
**Figure 4: Cross-border net direct and portfolio investment flows in USD billion, world total, 1980–2020, BoP statistics.**



Note: Positive value means net capital outflow, and negative value means net capital inflow. FDI – foreign direct investment, PI – portfolio investment

Source: World Economic Outlook database, April 2021.

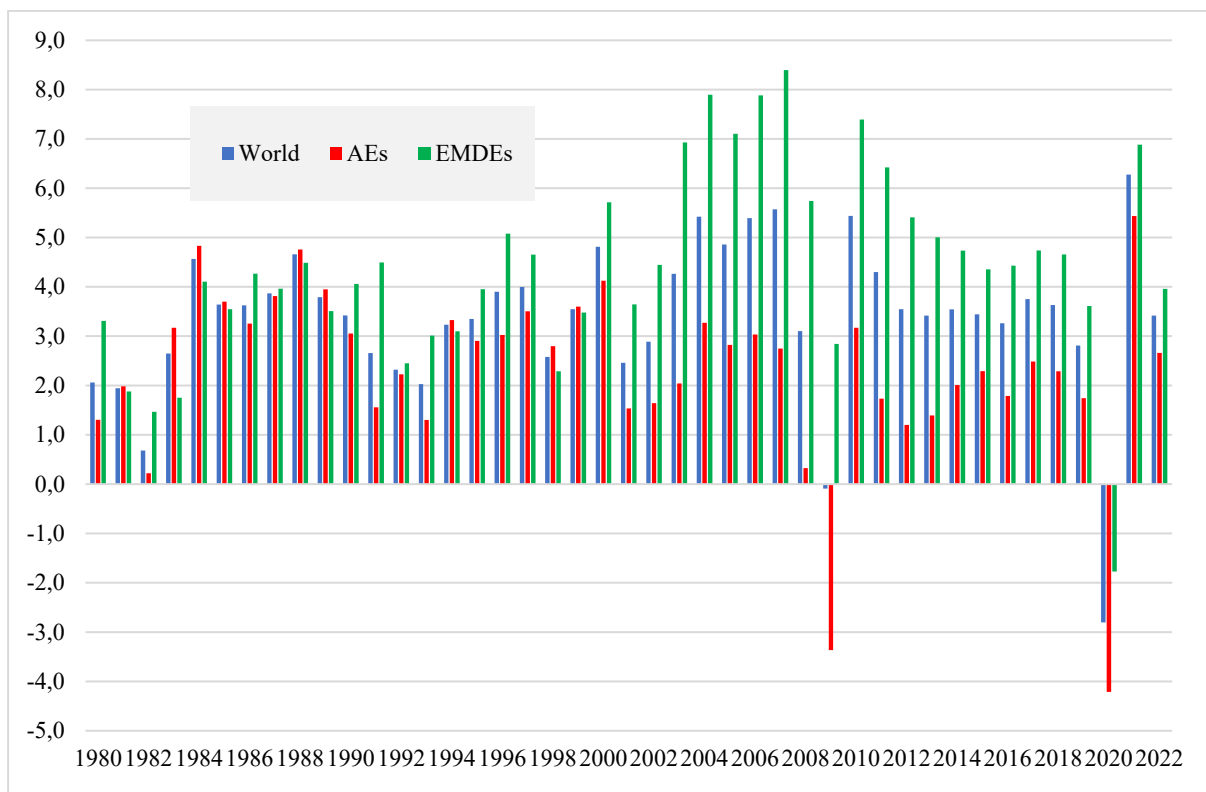
**Figure 5 The Chinn-Ito Capital Account Openness Index (KAOPEN), 1970–2018.**



Notes: The Chinn-Ito Capital Account Openness Index is based on the information from the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER). The current and capital account control degree is normalized within the scale of  $-1.92$  (minimum openness) and  $2.33$  (maximum openness). Data in Figure 4 represent simple averages of indexes of respective groups of countries. The entire sample amounts to 182 countries.

Source: Chinn and Ito (2006); Ito and Chinn (2020); [http://web.pdx.edu/~ito/Chinn-Ito\\_website.htm](http://web.pdx.edu/~ito/Chinn-Ito_website.htm); [http://web.pdx.edu/~ito/Chinn-Ito\\_website.htm](http://web.pdx.edu/~ito/Chinn-Ito_website.htm) and author's calculation.

**Figure 6: GDP, constant prices, % change, 1980-2022**



Source: IMF World Economic Outlook database, April 2023

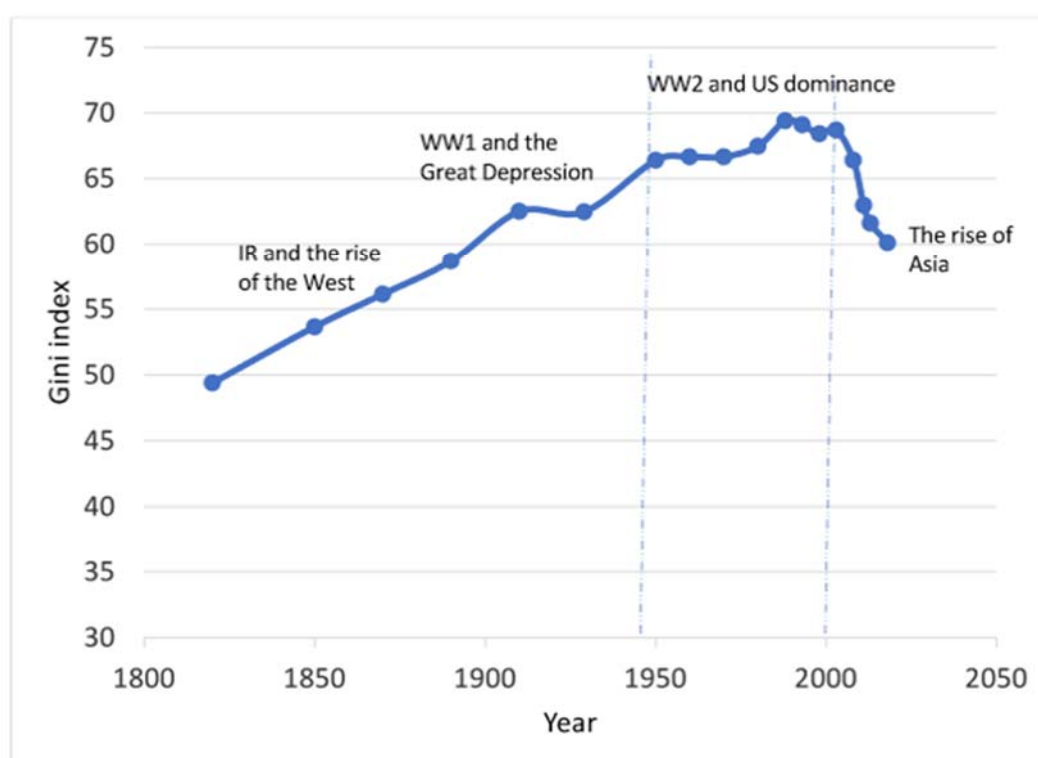
**Figure 7: GDP, constant prices, % change, regional decomposition, 1980-2022**

**Table 2: Poverty headcount ratio at \$2.15 a day (2017 PPP) (% of the population), 1981-2019**

Region	1981	1986	1991	1996	2001	2006	2011	2016	2019
East Asia & Pacific	83.5	68.3	63.9	45.5	37.2	21.0	10.4	2.3	1.2
Europe & Central Asia	..	..	3.7	8.3	8.3	5.5	3.8	2.8	2.3
Latin America & Caribbean	15.1	12.4	16.1	16.2	13.2	8.5	6.0	4.4	4.3
Middle East & North Africa	..	7.3	6.9	4.8	3.5	2.6	2.2	6.0	..
South Asia	58.0	52.3	49.0	41.9	..	33.5	21.4	15.8	8.6
Sub-Saharan Africa	..	..	55.7	57.6	55.5	47.4	41.0	37.2	34.9

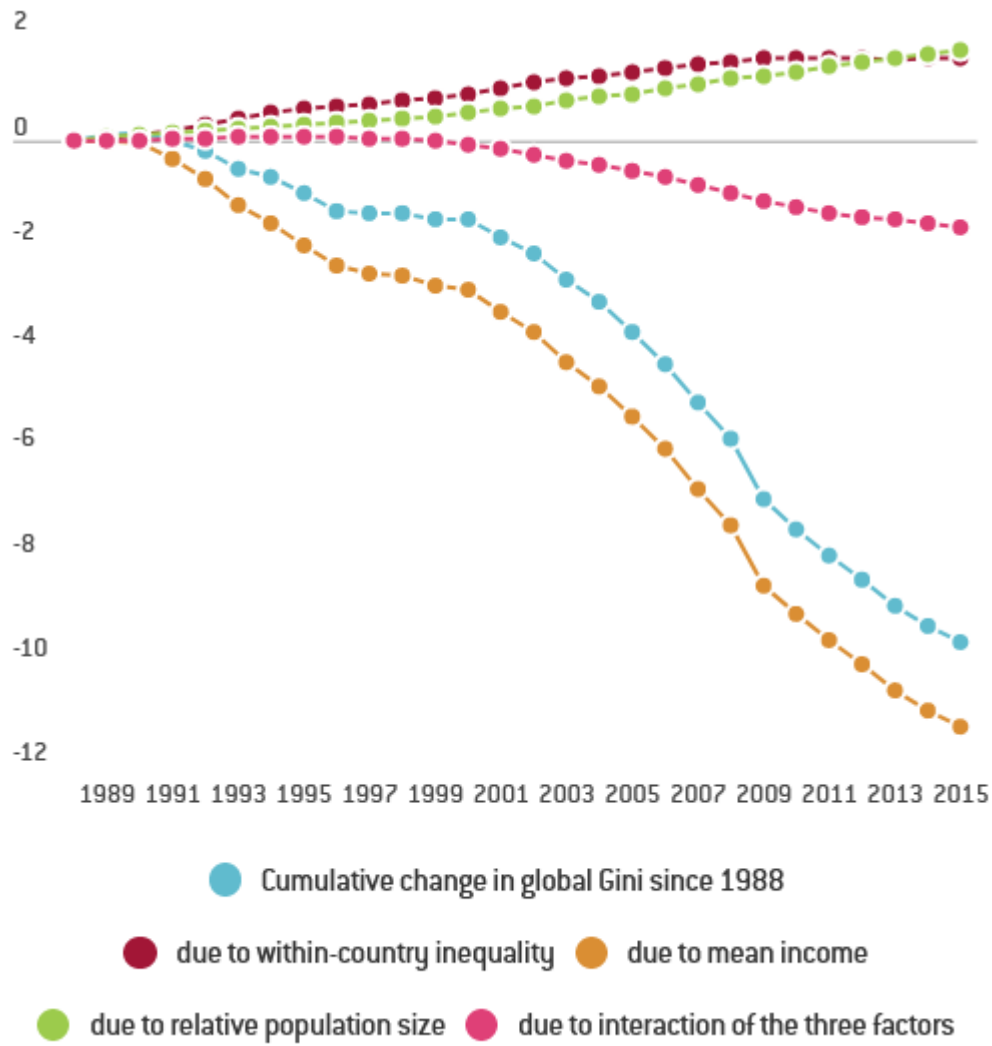
Source: World Bank's World Development Indicators

**Figure 8: Estimated global income inequality, 1820-2018**



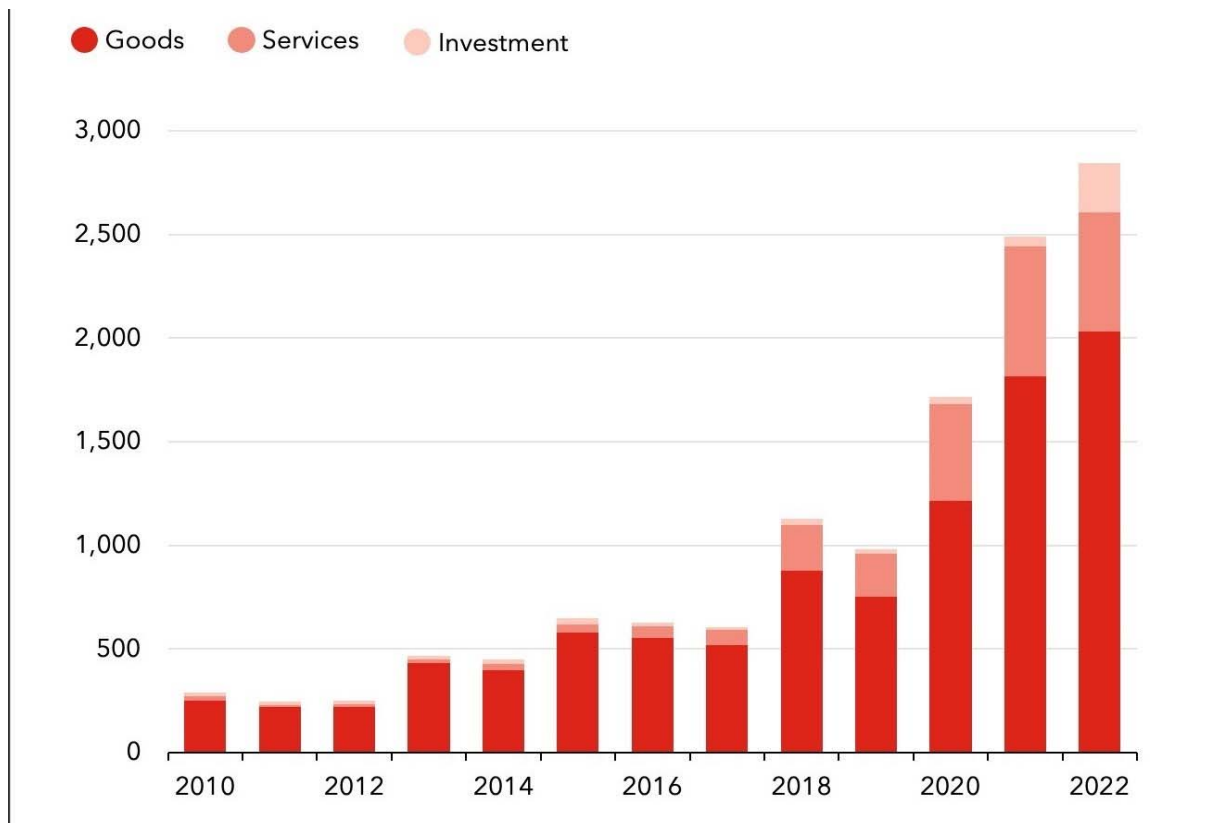
Source: Milanovic (2020)

**Figure 9: Change in the global Gini coefficient of income inequality, 1988-2015**



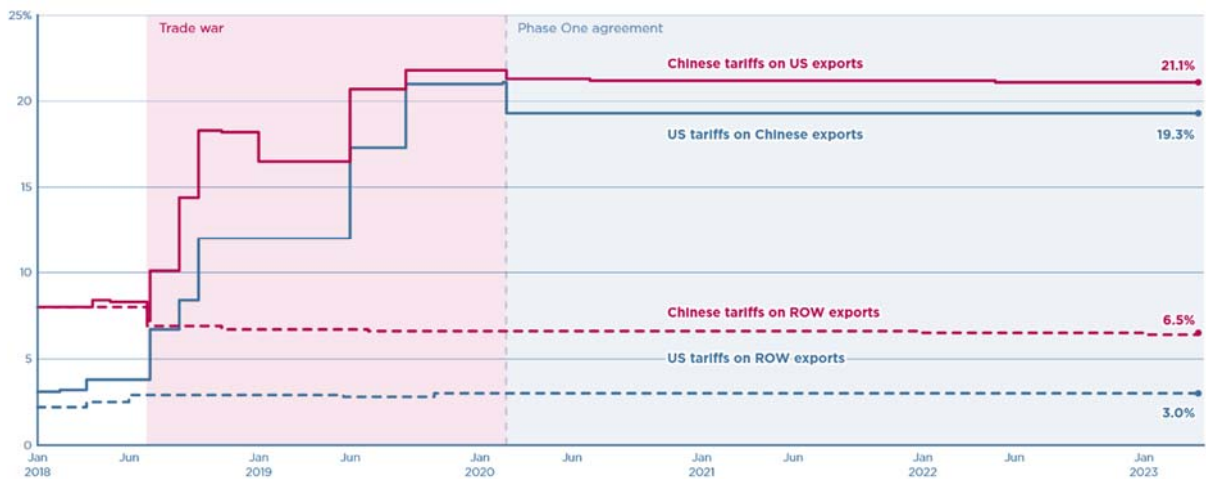
Source: Darvas (2018)

**Figure 10: Number of trade restrictions imposed annually worldwide**



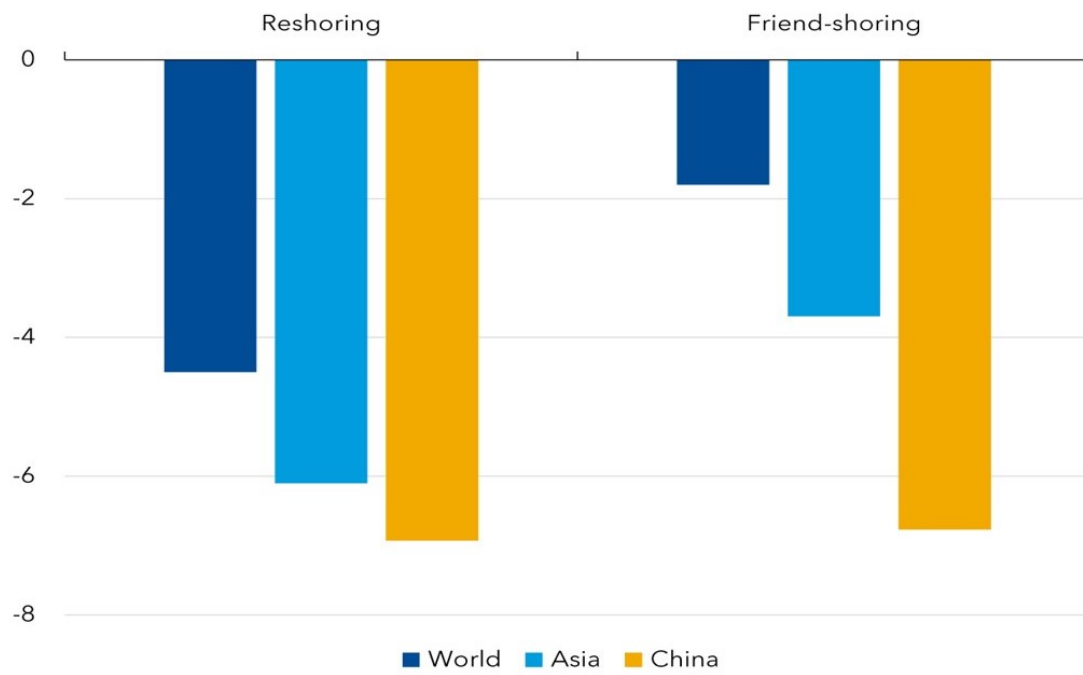
Source: <https://www.imf.org/en/Blogs/Articles/2023/08/28/the-high-cost-of-global-economic-fragmentation>

**Figure 11: US-China tariff rates toward each other and the rest of the world (ROW)**



Source: Bown (2023a)

**Figure 12: Losses from friend-shoring and reshoring scenarios (GDP, % deviation from the baseline scenario)**



Source: Cerdeiro et al., 2023