Special Commentary — February 21, 2023

Globalization in Retreat: Implications for the U.S. Economy

Part I: Introduction

Summary

- The world has gone through two episodes of globalization in recent centuries. The first started in the late 19th century and ended with the onset of the First World War. The second episode coincided with the fall of the Berlin Wall and the rise of China as an economic superpower.
- However, there are signs that the second era of globalization may be topping out, if not going into reverse. We will explore the potential effects that a reversal in globalization may have on the U.S. economy in a five-part series that we will publish over the next few weeks.
- American direct investment abroad and foreign direct investment in the United States rose markedly beginning in the 1990s. However, these flows have been more or less flat in recent years. We will discuss the implications of smaller cross-border investment flows in Part II of this series.
- Perhaps no sector in the U.S. economy has been as affected by globalization as the manufacturing sector. Offshoring of factory jobs contributed to the sharp drop in manufacturing employment that occurred starting in the late '90s. But manufacturing employment has experienced a renaissance of sorts in recent years. Will the number of American factory jobs continue to trend higher if globalization goes into reverse? We will discuss further in Part III.
- Rising import penetration contributed to the disinflation that occurred in the U.S. economy in the '90s and '00s. We will analyze potential effects of globalization's reversal on inflation in the United States in Part IV.
- We will offer our overall conclusions in Part V of this series.

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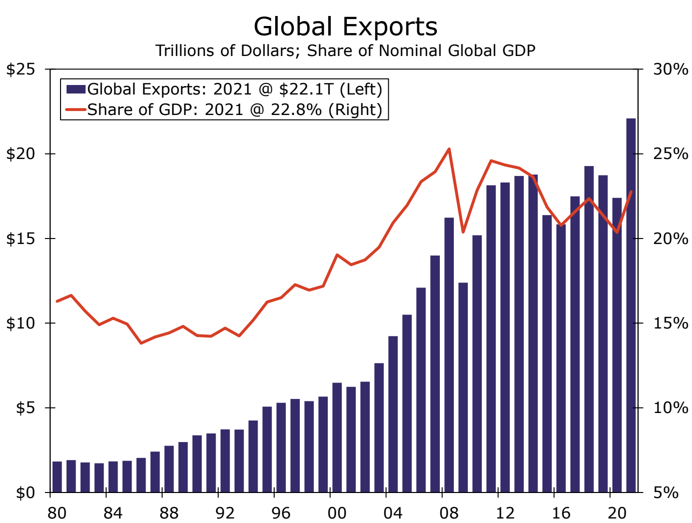
The Second Era of Globalization Looks to Be in Retreat

As defined by the Peterson Institute for International Economics, globalization is "the growing interdependence of the world's economies, cultures and populations, brought about by cross-border trade in goods and services, technology and flows of investment, people and information."[1] The world has gone through two episodes of globalization over the past few centuries. The first episode started in the late 19th century and roughly coincided with the heyday of the gold standard. Great Britain led the world in reducing trade barriers, and capital flowed freely from London to many foreign destinations. This period of globalization collapsed with the onset of the First World War, and globalization lay dormant through the Great Depression, the Second World War and the first few decades in the immediate aftermath of WWII.

The economies of Western Europe, North America and Japan more or less comprised the "global" economy for much of the post-WWII period.

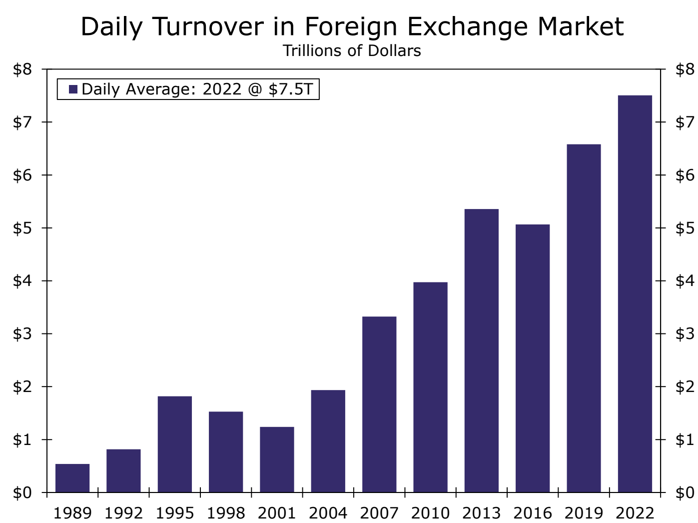
The economies of Western Europe, North America and Japan more or less comprised the "global" economy between the end of the Second World War and 1989. Trade between these western economies and the Soviet bloc was essentially nonexistent, and China was largely an agrarian economy as recently as a few decades ago. But the fall of the Berlin Wall in 1989 brought about increased trade and investment flows between western economies and the countries of the former Soviet bloc, and China's accession to the World Trade Organization (WTO) in 2001 accelerated the integration of the world's most populous country with the rest of the world. The ratio of global exports-to-global GDP averaged roughly 15% between 1980 and the early 1990s (Figure 1). But this ratio began to trend higher starting in the mid-1990s, and it accelerated in the years immediately preceding the global financial crisis of 2008. Data on cross-border flows of portfolio investment on an overall global basis are not readily available, but time series data on daily turnover in the foreign exchange market are instructive. Data from the Bank for International Settlements (BIS) show that turnover in the FX market averaged roughly $500 billion per day in 1989 (Figure 2).[2] In less than 20 years, daily turnover had exploded sixfold to more than $3 trillion in 2007.

Figure 1



Source: International Monetary Fund and Wells Fargo Economics

Figure 2



Source: Bank for International Settlements and Wells Fargo Economics

But there are indications that the second era of globalization may have topped out, if not begun to go into reverse. For example, geopolitical tensions between the United States and China have risen in recent years, and Russia's invasion of Ukraine has been roundly criticized by most western nations. Furthermore, indications of globalization's retreat extend beyond pure geopolitics into the economic realm. A full discussion of the effects that the backsliding on globalization may have on the global economy is beyond the scope of our current analysis. Rather, we will focus more narrowly on the effects that a reversal of globalization may potentially have on the U.S. economy in a series of five reports that we plan to publish over the next few weeks.

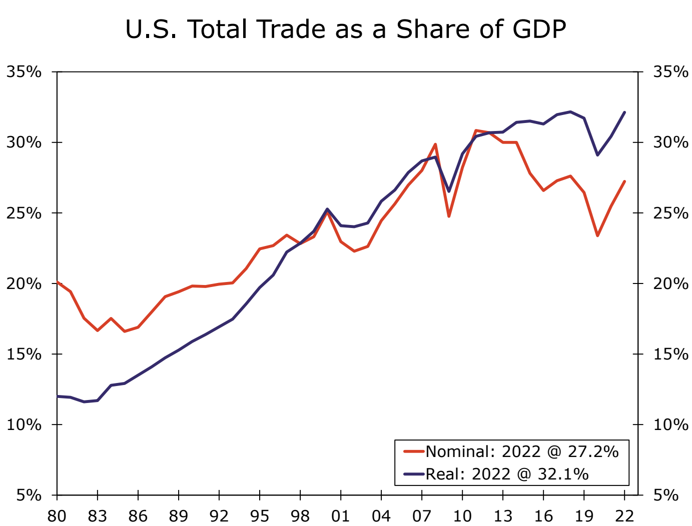
U.S. Trade & Investment Flows with the Rest of the World Have Topped Out

__The trade-to-GDP ratio in the U.S. economy is no longer rising.__

As noted previously, the ratio of global exports-to-global GDP rose markedly in the 1990s and the first decade of the 21st century as the second era of globalization got under way (Figure 1). But this ratio has subsequently trended lower since its peak in 2008. The international trade ratios of the United States show a similar pattern. Whether measured in real or nominal terms, the ratio of international trade- (i.e. exports and imports of goods and services) to-GDP rose in the '90s and '00s (Figure 3). However, these ratios have remained largely unchanged (real) or moved lower (nominal) over the past decade or so.

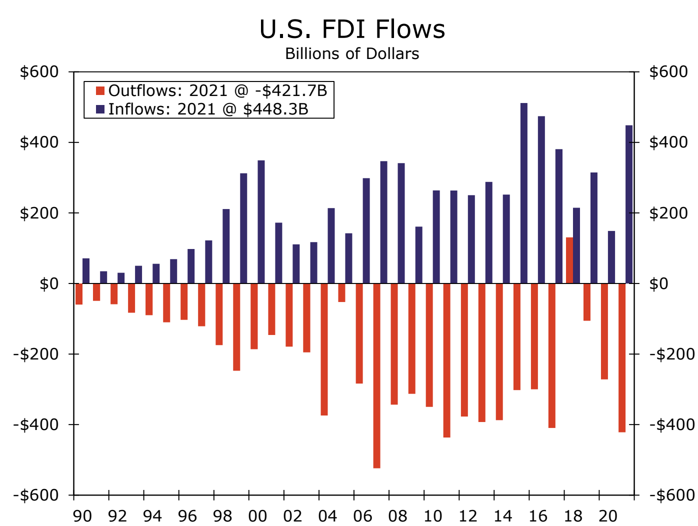
Not only does American interaction with the rest of the world via trade flows appear to be topping out, but investment flows also seem to have stalled. Outflows of foreign direct investment (FDI) from the United States rose sharply in the late 1990s and the first decade of this century, shooting up to more than $500 billion in 2007, as American producers moved production facilities abroad (Figure 4).[3] At the same time, FDI flows into the United States from foreign economies also increased markedly. However, the two-way flow of FDI capital has stopped growing. When expressed as a percent of nominal GDP, the flow of U.S. direct investment abroad has been cut in half from 3.6% in 2007 to 1.8% in 2021. In short, it appears that American businesses are not as interested in moving production facilities to foreign economies as they were a decade or two ago. FDI inflows have also receded in recent years, both on an absolute basis and when expressed as a percent of GDP. What are the implications for the American economy if the United States ceases to integrate further with the global economy via trade and FDI flows? We will explore this topic in greater detail in Part II of this series.

Figure 3



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 4

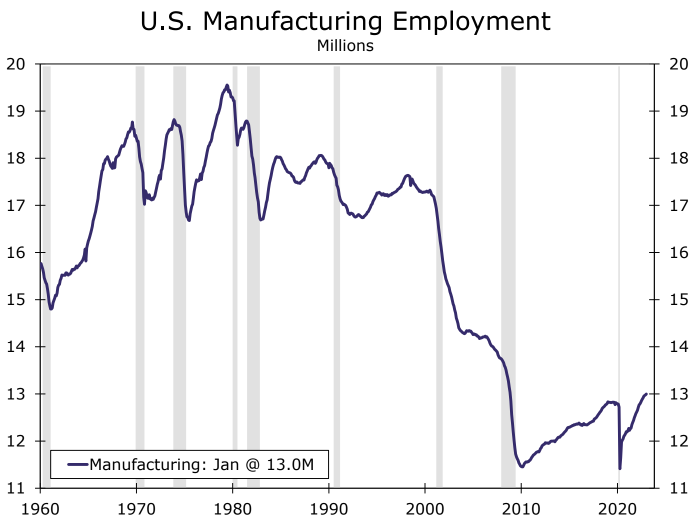


Source: U.S. Department of Commerce and Wells Fargo Economics

Will the Number of American Factory Jobs Continue to Rise?

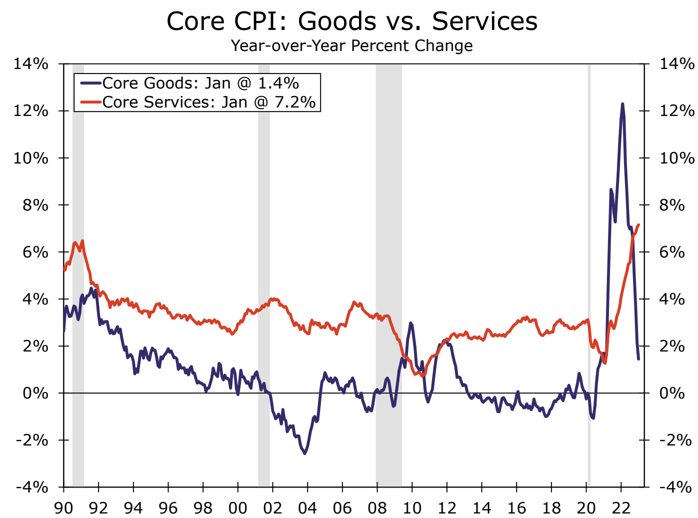
As noted earlier, American companies moved production facilities abroad in the '90s and the '00s to realize lower production costs as formerly closed economies opened up to the rest of the world. This offshoring of production facilities was associated with a sharp drop in manufacturing employment in the United States. Between early 1998 and early 2010, the number of American factory jobs nosedived by more than 6 million (Figure 5). The economic downturns of 2001 and 2007-09 clearly contributed to the plunge in factory jobs, but the offshoring of production facilities undoubtedly weighed on manufacturing employment as well during those years. However, the number of factory jobs in the United States has risen by roughly 1.5 million since early 2010 as the outflow of U.S. FDI has slowed. If globalization goes into reverse in coming years, will manufacturing employment in the United States enjoy a renaissance? We will delve deeper into this topic in Part III of this series.

Figure 5



Source: U.S. Department of Labor and Wells Fargo Economics

Figure 6



Source: U.S. Department of Labor and Wells Fargo Economics

Imports Exerted Downward Pressure on U.S. Inflation

Finally, globalization has had an effect on U.S. inflation, and its reversal could potentially have implications for consumer prices. Goods account for more than 80% of total American imports—services comprise the remainder—and the surge of imports that occurred in the '90s and the '00s exerted downward pressure on good prices in the United States. As shown in Figure 6, year-over-year changes in prices of both goods and services started to trend lower in the early 1990s, but goods prices decelerated more than service prices. Indeed, prices of "core" goods (i.e. goods excluding food and energy) were essentially unchanged on balance between the beginning of 2000 and the end of 2019. In contrast, "core" service prices rose more than 70% (2.8% per annum on average) during those years. Will goods prices face upward pressure if a retreat from globalization leads the United States to import less in coming years? We will explore the effect that deglobalization may have on U.S. inflation in Part IV of this series. Our fifth report will offer our overall conclusions from the series.

Endnotes

1 "What is Globalization?: And How Has the Global Economy Shaped the United States?", Peterson Institute for International Economics, October 2022. (Return)

2 Turnover in the FX market includes spot transactions, outright forwards, FX swaps, options and currency swaps. (Return)

3 FDI outflows turned negative (i.e. the bar in Figure 4 flipped into positive territory) as the 2017 Tax Cuts and Jobs Act induced businesses to repatriate nearly $300 billion worth of profits that were held abroad. (Return)

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