WELLS FARGO

International Commentary — September 13, 2023

The Rise of Deglobalization: Part 1

Summary

Globalization—the rising interconnectedness of the world's economies—has ended. The prior environment of frictionless trade and the free movement of capital, people, information etc. is over, and the global economy is currently in a period of deglobalization. In fact, deglobalization began in the wake of the 2008-2009 Global Financial Crisis; however, the fragmentation of the global economy has picked up pace over the last fifteen years with the rise of protectionist policies, escalating geopolitical tensions and COVID. In this first report of a series focused on deglobalization, we discuss the fracturing of the global marketplace as well as the role China plays in the disconnecting of the global economy.

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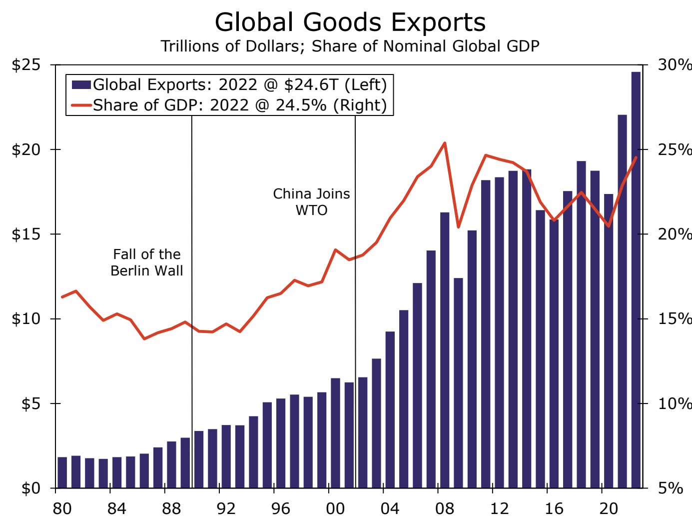
The Rise and Fall of Globalization

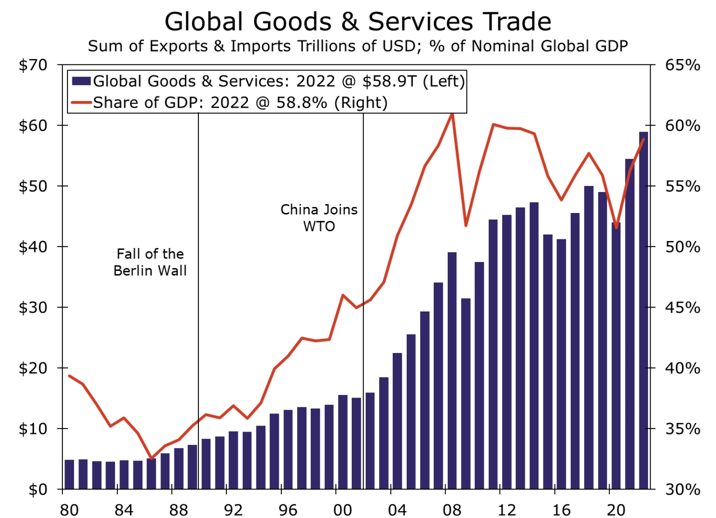
Earlier this year, our U.S. economics colleagues published a series of reports on the state of globalization. In these reports, our colleagues make the case that globalization has stalled, the interdependence of economies around the world has halted, and the U.S. economy could be negatively affected as a result. Our teammates highlighted that the first wave of globalization occurred in the late 19th century and picked up pace as Great Britain lifted trade restrictions. Goods, services, capital, technology, information and people flowed across borders more seamlessly than any other time in history. World War I ended the initial globalization era, while the onset of the Great Depression and World War II kept globalization at bay for subsequent decades. Globalization efforts picked up again in the late 1980s and gathered momentum with the fall of the Berlin Wall in 1989. China entering the World Trade Organization (WTO) in 2001 accelerated the second phase of globalization, and economies around the world became more dependent on each other and more interconnected than ever before. Data clearly show the Berlin Wall collapse and China entering the WTO boosted global trade. Following Germany's reunification and opening up to the rest of the world, global goods exports as a percent of the global economy rose quickly, from 15% in 1989 to 18% in 2001 (Figure 1). China's accession to the WTO had a more significant impact on globalization. Following China's entrance to the global trade organization, the global goods exports-to-global GDP ratio jumped from 18% in 2001 to over 25% in 2008. We can observe a similar trend for overall global trade (i.e., the sum of goods and services exports as well as imports). Following the fall of the Berlin Wall, the global goods and services trade rose notably, while China's ascension to the WTO propelled the second era of globalization to new heights. Overall global trade during the second phase of globalization rose to over 60% of global GDP in 2008 from 33% in 1986 (Figure 2).

Figure 1



Source: International Monetary Fund and Wells Fargo Economics

Figure 2

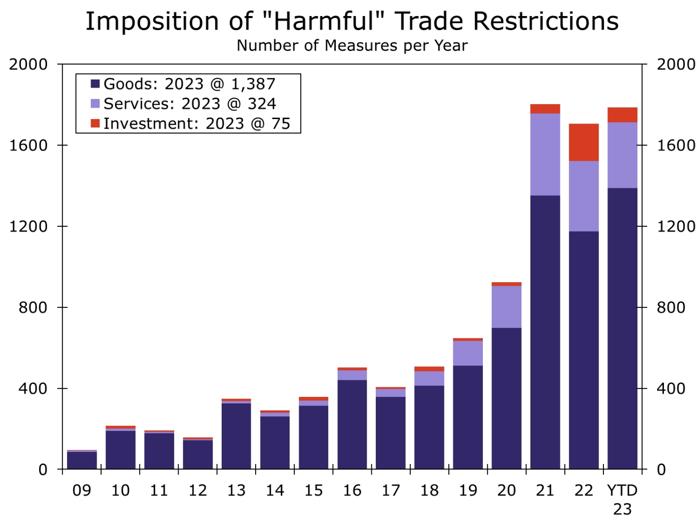


Source: IMF, UNCTAD and Wells Fargo Economics

However, recent trends in these data suggest this latest era of globalization is over. The 2008-2009 Global Financial Crisis (GFC) marked the inflection point for the second phase of globalization. In 2008, global trade in goods and services was worth over 60% of global GDP. Following the Global Financial Crisis, global trade as a percent of global economic output has been on an overall downward trajectory. While the GFC may have been a catalyst for deglobalization, multiple developments over the past 15 years have intensified global economic fracturing and have reduced the overall interdependence of the world's economies. The European Debt Crisis in 2010 reduced confidence in the Eurozone bloc and escalated concerns regarding the cohesiveness of the European Monetary Union. Soon after, anti-European movements gathered momentum. “Brexit” eventually contributed to a fragmented Europe and less intra-Europe trade cooperation. Similar protectionist-style policies became a global phenomenon and were particularly implemented under the Trump administration in the United States. Unilateral renegotiation of trade agreements with select trading partners and tariff policies erected new barriers to trade involving the U.S., particularly trade with China. Chinese authorities imposed reciprocal tariffs on the U.S., investment restrictions and other trade regulations in response, while American allies in western countries also exhibited efforts to contain China's economic influence

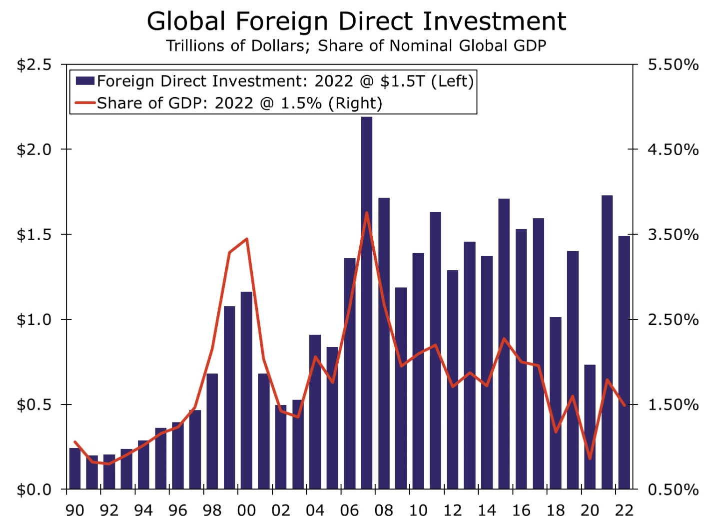
through the implementation of trade barriers. COVID also led to a rise in protectionist sentiment as countries around the world placed export restrictions on food and medical products. Even as the impact of the pandemic on health and human services has eased, trade restrictions have yet to be lifted with any meaningful significance. According to Global Trade Alert, “harmful” trade restrictions that reduce the inter-connectedness of the world's economies increased in the years leading up to the pandemic and picked up significant momentum starting in 2020. COVID-era trade restrictions rose in years following the onset of the pandemic and were still well above pre-pandemic levels as of the end of 2022 (Figure 3). Trade restrictions are still being implemented in 2023. Just through the end of August, more goods-related export limitations have already been put in place relative to the past two years. Investment restrictions and services trade limitations continue to be implemented as well, and at this pace, 2023 could wind up being the most protectionist that global trade policy has been in some time.

Figure 3



Source: Global Trade Alert and Wells Fargo Economics

Figure 4



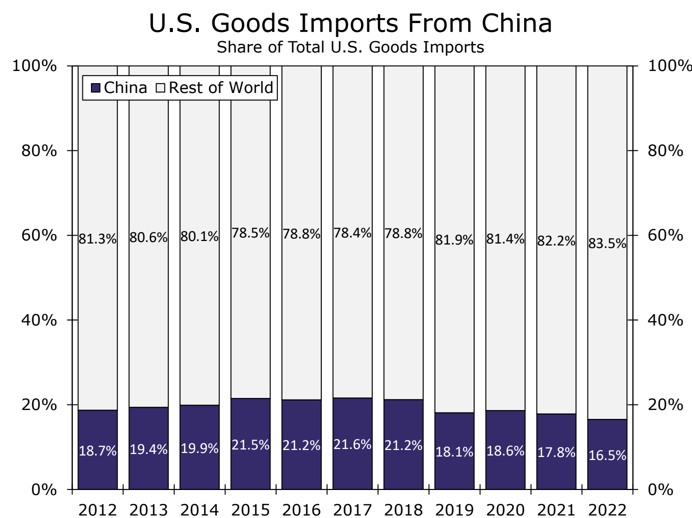
Source: UNCTAD and Wells Fargo Economics

The latest period of deglobalization has roots in rising protectionism; however, we would be remiss not to mention the impact geopolitical developments have had on deglobalization as well. There are aspects of protectionist policies that stem from geopolitics, but more recent and explicit geopolitical events have had a pronounced impact on the declining state of globalization. Russia's invasion of Ukraine is the most obvious and significant example. Russian hostilities toward Ukraine prompted one of the most aggressive and coordinated sanctions responses ever imposed by the United States and its allies. Sanctions have disrupted trade associated with Russia, and given Russia's position as a major oil exporter, the latest sanctions regime has further contributed to deglobalization. Countries strategically and geopolitically aligned with Russia since the invasion have also been economically isolated and essentially removed from the global marketplace. While this includes countries less integrated into the global economy such as Belarus, China has also maintained its allegiance toward Russia and has been the target of further trade restrictions over the past few years. Combined with protectionism and nationalism, geopolitical events have not only contributed to a reduced global goods and services trade, but also to a sharp decline in foreign direct investment (FDI) flows around the world. Similar to global trade, the Global Financial Crisis marked an inflection point for FDI. Before the Global Financial Crisis unfolded, FDI was worth over 3.5% of global GDP. As geopolitical events took shape, combined with rising protectionist and nationalist policies, FDI is now worth just 1.5% of global economic output (Figure 4). While we have limited visibility into the exact evolution of the Russia-Ukraine conflict and other major geopolitical event risks, we believe current geopolitical tensions are likely to continue into the future. As a result, we believe further deglobalization is more likely than a period of re-globalization. This deglobalization extends to not just the global exchange of goods and services, and cross-border investment flows, but also the movement of people, technology and information. Deglobalization and its underlying forces have also sparked discussions about the need to diminish the role of the U.S. dollar in the global marketplace and the possibility of new currency blocs being formed.

China's Role in Deglobalization

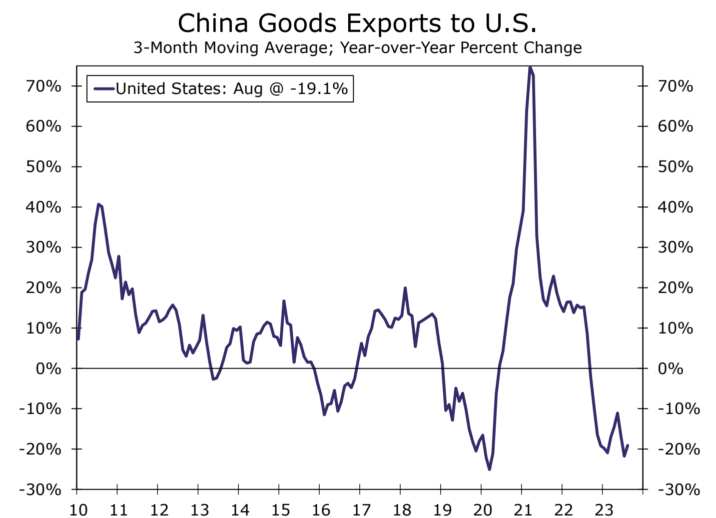
The deglobalization story is difficult to tell without focusing on China. Of these events of the past 15 years, China has played an important role in just about all of them. During the Trump administration in the United States, tariff policies were significantly directed at China. The U.S.-China trade war raised import costs for many U.S.-based corporations and placed downward pressure on consumer spending and corporate profitability in select industries. In response, many affected corporations looked for cheaper alternatives in an effort to replace China in their respective supply chains. Soon after U.S.-China trade tensions took shape, the COVID pandemic hit. China's strict and sporadic lockdowns upended supply chains around the world and exacerbated the desire for corporations to eventually diversify supply chains away from China. On top of tariff policies and lockdowns, Chinese authorities more aggressively implemented "common prosperity" policies aimed to redistribute wealth and close the inequality gap. The unorthodox and unpredictable nature of common prosperity policies raised questions about China as an investment destination, both from the point of view of speculation and from a strategic perspective. Along with China's involvement and alignment on multiple geopolitical fronts, as well as China's deteriorating economic outlook, empirical data indicate that supply chains are indeed shifting away from China. To that point, U.S. goods imports from China have been steadily declining. In 2015, the U.S. imported 21.5% of all of its goods imports from China. As of the end of 2022, goods imports from China dropped to 16.5% (Figure 5). Higher frequency data from China's National Bureau of Statistics show the decline in exports to the United States is gathering momentum in 2023. Through August, on a three-month moving average basis, Chinese exports to the U.S. are down 19.1% year-over-year (Figure 6). August data are on par with the decline in exports experienced toward the end of 2022-early 2023 when China was still operating under "Zero-COVID" protocol, and close to the trough in early 2020 during the original COVID-induced lockdowns.

Figure 5



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 6

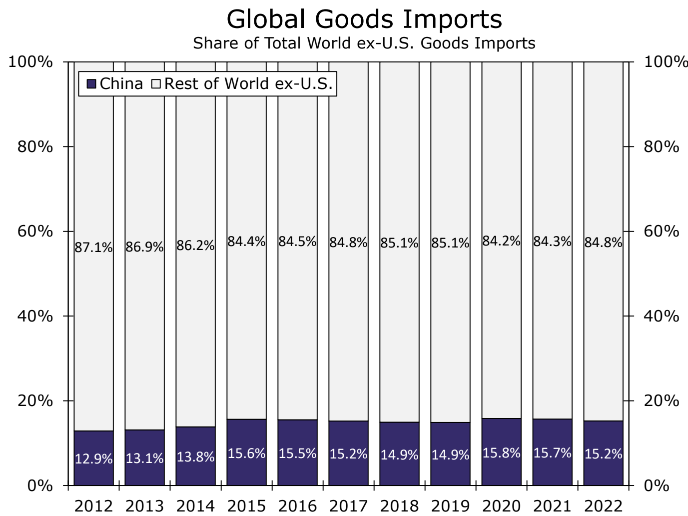


Source: Bloomberg Finance L.P. and Wells Fargo Economics

Import data for international economies send mixed signals on China's status in supply chains around the rest of the world. Generally speaking, China is tightly integrated into international economy supply chains, but at the same time, recent trends signal that China is slowly being replaced as a manufacturing hub. To that point, about 13% of global ex-U.S. imports were coming from China in 2012. Imports peaked in 2015 when China supplied 15.6% of goods to international economies. From 2016-2019, dependency on China started to slip as goods imports gradually declined to 14.9% in 2019; however, COVID boosted international economies' reliance on China, in part due to the emergency need for medical products. Imports of goods rose sharply in 2020 and stayed elevated in 2021, a trend that only partially existed in the United States. As the health impact of COVID and the emergency need for medical products has eased, international imports from China have come down, but remain above pre-pandemic levels as of the end of 2022 (Figure 7). However, the same China National Bureau of Statistics exports data suggest that China is again being removed from global supply chains in 2023. China goods exports to the world ex-U.S. are down significantly over the course of this year. Granted, a portion of the decline in exports could be attributed to less robust

global growth and global demand. But given China's sharp economic deceleration and the dynamics mentioned earlier, we believe this decline in exports is more driven by a concerted effort to diversify supply chains away from China.

Figure 7



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 8

Source: Bloomberg Finance L.P. and Wells Fargo Economics

We mention deglobalization and China's role in this phenomenon as a way of saying global economic growth could be negatively affected as a result of a less interconnected world. Economic fragmentation means less trade cooperation, and with the world's two largest economies heavily involved in that fragmentation, the negative repercussions of less global trade and deglobalization could be quite severe. In the second part of our series of reports on deglobalization, we will offer potential ramifications of economic fragmentation and how global GDP growth could evolve in a deglobalized world. We will draw further inspiration from the IMF and provide insight into how much global GDP growth could be cut if deglobalization picks up pace, and what a “new normal” rate of growth for the global economy could look like. In addition, we will discuss select economies that—even as the global economy in totality could be negatively affected—have already benefited from China's removal from global supply chains and which countries could act as viable strategic alternatives to China over the long-term.

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