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Globalisation and fragmentation

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The word 'globalisation' can mean different things to different people or in different environments. In its broadest sense, globalisation includes not only economic but also technological, social, cultural and political aspects, which are not easy to disentangle. Similarly, it has generated and continues to generate criticism, enthusiasm and fear, which cannot be ascribed to one dimension alone, be it economic, social or technological.

That said, I think that following the development of this process from the point of view of an economist allows us to grasp some important aspects that can contribute to our debate today, indicating, even if only tentatively, present risks and future prospects.

After decades of rapid economic and financial integration, today's world is closely interconnected. Globalisation has expanded international flows of goods, services and capital, as well as of persons, ideas, knowledge and information. It has helped to promote lasting growth and to reduce poverty on a global scale. And yet, some of the contributory factors now seem to be under discussion.

The achievements I have mentioned are not abstract concepts, nor are they mere statistics. My contemporaries cannot have forgotten the dramatic spectacle of the physical deprivation experienced by much of the world's population fifty to sixty years ago, or the repeated appeals for the individual or collective humanitarian aid needed to alleviate at least the most severe suffering. In the first decades after the Second World War, the world was divided between North and South, no less than it was between East and West, though for very different reasons.

Things have changed a great deal since then, as much in people's living conditions as in the relationships between countries. For example, the share of people suffering from malnutrition globally has decreased from 34 to 13 per cent in the last half century, while the population has more than doubled. Using a more general measurement of economic

1 I would like to thank Alessandro Borin, Riccardo Cristadoro, Enrica Di Stefano and Filippo Vergara Caffarelli, who helped me prepare this speech.

deprivation, and a shorter time frame, the World Bank estimates that globalisation made it possible for more than a billion people to emerge from conditions of extreme poverty between 1990 and 2015.[2] The opening up to trade and to the market economy allowed demographic giants like China and India to become economic giants as well; they have grown at a formidable rate, greatly reducing the gap with the advanced economies, and finally taking their place at the table of global governance.

For many years, greater economic integration went hand in hand with improvements in political and diplomatic relations between countries, strengthening the widespread conviction that it was precisely these interdependencies that would help to preserve peace and create the right conditions for shared development. Improved diplomatic relations between China and the West following Deng Xiaoping's rise to power and the normalisation of relations with former Soviet countries after the fall of real socialism have also been decisive aspects in the process of economic integration.

In the years following the Great Financial Crisis of 2008, the consolidation of the G20 as the preferred forum for the global coordination of economic policies can be seen as symbolising a process that seemed to mark the end of both the undisputed economic predominance of the traditional advanced countries and the rigid division into blocs that had marked the Cold War decades.

More recently, however, the race towards integration has lost momentum. In the advanced countries, an increasingly popular narrative puts globalisation at the root of both a slowdown in growth in these countries and greater inequalities. The global economy is now more often seen as a playing field, on which the advanced countries are described as losers, and less as a producer of greater wellbeing for all. In some emerging countries, economic growth has not been flanked by an improvement in human rights and in democracy, as many in the West had perhaps hoped. The political framework that had encouraged growth has weakened, and perhaps some factors that had accelerated it in previous decades have faltered and economic globalisation itself has begun to slow down.

These concerns, which had already been nurtured by the repercussions of the financial crisis 15 years ago, have become more apparent in recent years. The 2020 pandemic seemed to throw into crisis the very mechanisms on which globalisation was based, highlighting the potential *physical* fragility of flows of goods over long distances. Russia's invasion of Ukraine in 2022 called into question the principle of peaceful coexistence between nations within internationally recognised borders, highlighting political and strategic risks and fuelling dependence anxiety in many countries and the search for self-sufficiency within 'friendly' areas.

Some signs of fragmentation are now beginning to be perceived. Owing to the effects of the two shocks of the last three years, global growth has followed a stop-and-go path. International trade, which had returned to growth after the pandemic, began to contract

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2 World Bank, Poverty and Inequality Platform, https://pip.worldbank.org/home.

again at the end of last year and is expected to slow sharply this year (1.8 per cent is the real rate of trade growth estimated by the Bank of Italy for 2023, down from 5.4 per cent in 2022). Cooperation between countries has become more difficult, above all since the war in Ukraine started by Russia, with all the losses and suffering involved, has deeply divided the international community. The machinery of global cooperation has been affected, from the G20 to the leading multilateral institutions, meaning that reaching important agreements has become more difficult in practice.

In the rest of this speech, I would like to draw your attention briefly to the events that led, first to the rampant emergence of globalisation and then to its slowing down, going on to consider some of the causes of this slowdown. I will then present the current debate on possible future scenarios, and although I am aware of the unsurmountable limits to our ability to think about the future, I will consider the possible implications of all this for 'tomorrow's world'.

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As I mentioned earlier, in the two decades preceding the 2008 financial crisis, the real and financial integration of the global economy progressed at an unprecedented pace. Many production processes started to become more complex and to develop over a wider area. The different stages of production were offshored across countries, leveraging comparative advantages at the individual production stage rather than for the whole process level ('global value chains'). Even when this shift was driven by the reorganisation of large multinational groups, it involved a huge number of smaller players across all continents.

The strong acceleration – or 'hyperglobalisation' in Dani Rodrik's definition – that took place between the late 1980s and the 2000s was driven by many institutional, technological and economic factors.[3] Some are by nature one-off occurrences, especially the fall of communist regimes in Europe and China's opening to international markets. Among other things, they gave Western firms access to low-cost skilled labour, facilitated offshoring, and paved the way for economic growth in emerging countries. Transport costs and tariffs have also eased significantly, as international political and diplomatic relations have improved and many trade barriers have fallen since the second half of the 1980s, even between countries that were geographically and culturally far apart. The average tariffs on imports of goods declined from 13.6 per cent in 1986 to 7.5 per cent in 2008.

The reduction of costs and the huge increase in communication capacity resulting from technological breakthroughs made it easier for firms to coordinate production units on a global scale. Similarly, the widespread take-up of the Internet, the introduction of smartphones and the success of social media provided an additional boost to digital integration by multiplying interconnections, expanding the dissemination of information and reshaping the international markets for capital, goods and services.[4]

3 Dani Rodrik, *The Globalization Paradox: Democracy and the Future of the World Economy*. New York and London: W.W. Norton, 2011.

4 A. Borin and M. Mancini. 'Follow the Value Added: bilateral gross export accounting', Banca d'Italia, Temi di Discussione (Working Papers), 1026, 2015.

During the hyperglobalisation period, world trade grew twice as fast as global GDP, with an even stronger expansion in the semi-finished sector. According to metrics developed by Bank of Italy researchers, the share of trade associated with global value chains increased from around 30 per cent in the late 1980s to more than 45 per cent in 2008.

The global financial crisis slowed down this powerful trend, but the process did not actually come to an end. Rather than deglobalisation, 'slowbalisation' set in, as per the term popularised by *The Economist*.[5] After all, as I said before, the faster phase of globalisation had been fuelled by exceptional events. Once these were over, and as the potential benefits of specialisation, wage differentials and the global organisation of value chains were reaped and then thinned out, a 'natural' deceleration could be expected.

Aside from these intrinsic factors, however, globalisation has also been held back by signs of a gradual shift in policy, which in advanced economies has become less unconditionally in favour of the free movement of goods and people. To some extent, this mirrors how more people have become sceptical of, if not openly hostile towards globalisation. Indeed, in advanced economies, its benefits (i.e. the availability of low-cost goods and services, the impetus to growth from emerging countries' demand) are widespread and in spite of their being vast and pervasive, are therefore barely noted, taken for granted almost. On the other hand, certain costs associated with international integration, especially if they are concentrated in specific population groups or sectors, are more obvious.[6] Above all, there has been a growing perception that the benefits of this process have been unevenly distributed.

If we consider the entire human population as a single community, the reduction in inequality in the last few decades has in fact been impressive,[7] and the contribution of globalisation to this improvement is undeniable. However, the trend of inequality *within* individual countries, especially in advanced economies, is far more controversial, to say the least. In some cases (United States, United Kingdom), income distribution indices show a concentration trend underway since the 1980s; another popular indicator, the share of income earned by the top 1 per cent of the population, has also surged. The trend is less clear in EU countries and Japan. For instance, inequality in Italy, as measured by the Gini index, fell sharply between 1970 and 1990; it then picked up (though staying far from previous levels) until the financial crisis, which temporarily reduced it again. It has now returned close to early-2000 levels. In some countries, the inequality trend has mainly reflected a relative setback in the middle or middle-to-low income group.

The causes of these trends are complex. To what extent the rise in inequality, where it has occurred, has been caused by globalisation, particularly by competition from countries with lower labour costs, is much debated by economists. Another key driver of changes in income distribution has been the lower need for low- and medium-skilled workers resulting from the growing use of digital technologies, which is at best only indirectly

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5 *The Economist*, 24 January 2019.

6 I. Colantone and G. Ottaviano (ed.). 'The Backlash of Globalization', CEPR Press Discussion Paper No. 16521, 2021.

7 B. Milanović, *Global Inequality: A New Approach for the Age of Globalization*, Harvard University Press, 2016.

linked to globalisation.[8] Aside from income distribution issues, a series of large shocks has also fuelled a perception of uncertainty, especially among the middle classes: the financial crisis, the pandemic and the war have doubtless weighed on both individual and collective financial prospects, and may have somehow nurtured the idea that unlimited cross-border integration may be a threat. I will return to this point shortly.

These facts or perceptions have added to the more direct and obvious damage that opening up to international trade can bring to some previously protected sectors. To give you an example, industrial production in the textile, clothing and leather goods sector shrank by one third in Italy between 1993 and 2019, and the number of people employed almost halved. In the long run, we can expect resources to be reallocated and welfare gains to become more widespread. In the very short term, however, while the limited damage has a clear impact, the benefits of global trade, which are considerable and widespread among consumers, are more difficult to understand and rarely feature in the mass media. In theory (according to economics books), it should always be possible to offset the former and preserve the latter to a large extent, but in practice it is neither conceptually nor politically easy to find a practical way to do so.

Whatever its underlying causes, the growing scepticism towards globalisation had already produced a few palpable effects, even before the most recent shocks. Along with escalating global strategic rivalries, this trend had started to weaken multilateral cooperation. The stalemate at the World Trade Organization and the failure of negotiations on major trade agreements somehow reflect this sentiment.

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The events of recent years have heightened concerns worldwide over the exposure of economies to global shocks, and have contributed to a tendency towards fragmentation in political and economic relations between countries and regions.

The outbreak of the COVID-19 pandemic highlighted certain vulnerabilities connected to the external supply of essential goods. During the post-pandemic recovery, the bottlenecks in the supply of key inputs brought to light some risks linked to production being offshored to various countries or concentrated in a few critical hubs. For example, the halt in production caused in many branches of manufacturing by the scarcity of semiconductors was one of the factors that slowed the recovery in supply and helped trigger the rise in global inflation in 2021.

Two years after the pandemic began, the Russian invasion of Ukraine flouted the key principles of international relations at a pitch not seen for many years. It has dispelled the illusion that economic interdependencies between countries could serve as a sure deterrent to the emergence of serious armed conflicts. On the contrary, these same interdependencies, the same decentralisation of production that had lowered costs have turned out to be vulnerability factors.

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8 R. Cristadoro, 'The unintended consequences of globalization and technological progress' in *International Macroeconomics in the Wake of the Global Financial Crisis*, L. Ferrara, I. Hernando and D. Marconi (eds.), Financial and Monetary Policy Studies, Springer, 2018.

We still do not know if the changes brought about by the war will last longer than those following the pandemic, but the risk should not be underestimated.

Shocks perceived as being temporary rarely have profound effects on economic integration. Various surveys conducted by the Bank of Italy suggest that few Italian multinationals had thought of radically revising their localisation strategies following the pandemic shock;[9] most of them had tried to strengthen their supply chains either by increasing their stocks or by diversifying their supply sources. This is no surprise: both the theory and the empirical evidence suggest that there is inertia in the localisation choices for factories and suppliers, owing to the considerable fixed costs of setting up in other countries and of creating stable trade relationships. A firm that has made significant foreign investments therefore has a strong incentive not to re-examine its choices following a shock, even a sizeable one, that is perceived as being temporary.

However, growing rifts in political and diplomatic relationships between countries may increase uncertainty to the point that the long-term outlook is altered as well. Although the official statistics on international trade and on investment still only show limited signs of any ongoing fragmentation, except for countries hit by sanctions, such as Russia, the number of protectionist measures is on the increase, including restrictions on direct foreign investments.[10] Directors of listed companies say they are considering reshoring, nearshoring or friendshoring strategies in their relations with investors, in response to international tensions and to the subsidy policies introduced by many countries.[11]

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In any case, the need to maintain the security of strategic supplies has influenced public policies almost everywhere.

In the EU, the Commission has acted according to the principle that pursuing the objective of strategic autonomy requires creating supply chains that can withstand external shocks and that guarantee access to vital resources (energy sources, semiconductors, rare earth elements); at the same time, it also requires firms to increase their ability to compete in strategic sectors.[12] To this end, in the words of Ursula von der Leyen, President of the Commission, a regulatory and policy framework will need to be ensured, 'coordinated between Member States and EU institutions and with a willingness to counter the divide and conquer tactics of third countries'.[13]

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9 *Di Stefano, E., Giovannetti, G., Mancini, M., Marvasi, E. and G. Vannelli, 'Reshoring and plant closures in Covid-19 times: Evidence from Italian MNEs', International Economics, 172, 255-277, 2022. On the supply strategies of firms in response to shocks, see also Buono, I. and F. Vergara Caffarelli, 'Trade Elasticity and Vertical Specialisation', Banca d'Italia, Temi di Discussione (Working Papers), 924, 2013.*

10 Evenett, S. J. 'What Caused the Resurgence in FDI Screening?', SUERF Policy Note, Issue No 240, 2022.

11 Aiyar S. et al. 'Geoeconomic Fragmentation and the Future of Multilateralism', *IMF Staff Discussion Notes*, 2023.

12 See the report by the International Relations Committee: 'The EU's Open Strategic Autonomy from a central banking perspective', ECB, 2023.

13 Speech given by President von der Leyen on EU-China relations at the Mercator Institute for China Studies and the European Policy Centre on 30 March 2023.

The capacity of the production system to react autonomously is not to be underestimated. As I said before, firms are already adopting measures to make their supply lines more resilient. According to a Bank of Italy survey conducted last year on a sample of manufacturing firms with at least 20 workers, around 60 per cent of firms had increased, or expected to increase their diversification in terms of input suppliers; about half were planning to increase their inventory levels by the end of the year.

It would seem advisable for public policies to focus on areas where private sector responses are expected to be less satisfactory, owing to externalities (for example, the network spillovers of disruptions in supplies) or to the specific nature of interventions (for example, sunk costs that are too high).

It is in any case to be hoped that, on a global scale, safeguarding national interests does not translate into indiscriminate protectionism and trade wars.

In principle, this is precisely the choice that the EU has made, by preparing a policy of ‘open strategic autonomy’. It is important to underline the concept of ‘openness’, which implies a willingness to pursue, as far as possible, an international order based on cooperation and on a system of shared rules. Nevertheless, we cannot deceive ourselves about the difficulties of the current situation.

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The risks linked to a potentially radical fragmentation are clear. Higher economic barriers would jeopardise the positive mechanisms that have stimulated growth and reduced global poverty over the last few decades. According to the International Monetary Fund, introducing massive restrictions on the trade of goods and services could cause losses of up to 7 per cent in world GDP. This estimate does not consider the additional impact that the probable reduction in labour mobility and in the spread of technology between countries could have in this scenario. In recent decades, the production chains that make up global value chains have been an important channel for spreading technological knowledge.[14]

The loss in efficiency caused by fragmentation would not be accompanied by a greater indiscriminate capacity to withstand shocks. The issue is actually a complex one and deserves more theoretical and empirical consideration. Intuitively speaking, if on the one hand, a highly interconnected network increases the spread of global shocks, on the other hand it makes it possible to limit the impact of localised ones.[15] Various studies,

14 Baldwin, R. *The Great Convergence*, Harvard University Press, 2016.

15 On another occasion, I happened to use an illustrative example concerning the power failure that occurred in Italy on 28 September 2003. As some of you will remember, a random tree falling down interrupted the energy supply from Switzerland; this interruption caused the rest of the grid to overload, which in turn led to several other cross-border energy lines and local generators shutting down. The entire country was plunged into darkness for hours, except for Sardinia (and a few smaller islands): if on the one hand, the isolation of a local electricity network may mean less efficiency and greater volatility under normal circumstances, on the other hand it may guarantee more resilience to external shocks (Signorini, L. F., ‘Of dogs, black swans and endangered species: a perspective on financial regulation’, a speech in honour of Andrew G. Haldane, Palermo, 15 December 2017).

including a recent paper by Bank of Italy researchers,[16] have confirmed that, by allowing firms to diversify their sources for input supplies and their outlet markets, the integration of international trade lowers their exposure to internal shocks, albeit at the cost of production being more sensitive to international shocks generated up- or downstream. Hence, the effect of a reshoring on the overall volatility of production is not unambiguous.

Finally, greater international fragmentation could hinder the search for workable solutions for producing global public goods, such as the energy transition or the fight against pandemics.[17] In the absence of a universal government with coercive powers and the capacity to impose taxes, the only feasible way to achieve such goals seems to be cooperation between sovereign entities: in other words, policies that are coordinated and agreed upon and, where necessary, financial agreements that are acceptable to everyone (the 'Coasean' way to produce public goods, if you will[18]). This path is intrinsically fraught with difficulty, but it would be so beyond measure in a world where trade barriers grew higher, strategic competition between blocs sharpened and the functioning of global multilateral institutions became increasingly arduous.

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What, then, is to be done? What will 'tomorrow's world' be like, and how would we want it to be? I believe there are no easy answers to the question, not even within the sphere of economic policy, which is the subject of this talk.

There is no denying we came to a watershed on 24 February 2022. From that point on, the pursuit of strategic defence, which has always been a chief concern of nation states, has again come to bear heavily on economic policy decisions, inevitably so, given the current situation.

Close confinement within one's national borders (the European borders, in our case), however, is not only expensive, but probably impossible. Some reshoring may take place, either as a choice of individual businesses, or as a direct or indirect reflection of decisions at a political level; but it is doubtful whether it could radically affect the international division of labour, both because of the sizeable investments made in the past and the extraordinary interconnectedness of our world today, at least, not unless any unforeseen catastrophes occur.

Friendshoring, i.e. relying solely on friendly states for at least some of the crucial links in a value chain, may be a viable option up to a point; however, besides the burden of past sunk investments, we run up against the uneven distribution of natural resources (which know nothing about friends and enemies) and the problem of deciding once and for all who may or may not belong in the trusted group.

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16 Borin, A., Mancini, M. and D. Taglioni. 'Measuring Exposure to Risk in Global Value Chains', Policy Research Working Paper; No. 9785. World Bank, 2022.

17 On this subject, see Rajan R., 'Joined at the hip: Why continued globalization offers us the best chance of addressing climate change'. The Per Jacobsson Lecture at the IMF/World Bank Annual Meetings, 15 October, 2022.

18 I alluded to this idea in Signorini, L.F., 'Conversing about Dante' Florence, 3 December 2021

Specifically, safeguarding trade integration among the advanced countries alone would probably be insufficient in the current context. Furthermore, the G7 no longer carries quite the economic weight it did a few decades ago. It is not easy to see how the G7 could build a future for itself in growing isolation, if not under extraordinary circumstances.

The goal, or rather the challenge of preserving as much as possible of what multilateral institutions do still stands, starting with the G20, the International Monetary Fund, the World Bank and the World Trade Organization. Access to natural resources, technology transfer, the smooth functioning of global finance, dealing with migratory flows, reducing the levels of poverty still afflicting vast stretches of the world, but also granting access to the more dynamic markets, are all objectives that cannot easily be pursued outside of multilateralism.

We should be under no illusions that a stable, linear course of action is at hand. However, I believe that, so far as broader political and strategic considerations allow (which are not for me to discuss), we should be pursuing potential avenues for economic cooperation not only with countries that share the fundamental values of western democracies, but also with countries that, while differing in more or less significant ways, are nonetheless willing, in practice, to interact on the playing field of the global economy according to a minimum set of rules for coexistence and a principle for resolving conflicts peacefully. As Raghuram Rajan has suggested, 'We need to create safe spaces where countries with differing values and systems can interact with confidence whatever the shifts in domestic politics or in the geopolitical landscape'.[19] This, I repeat, is a major challenge. While overcoming this challenge is in everyone's interests, the necessary goodwill, reasonableness and farsightedness cannot come from one side alone.

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Throughout history, there have been repeated cycles of economic opening and closure. It may not be wholly out of place to remind ourselves here of those ancient times when a prototype globalisation came into being in Europe and all along the Mediterranean shores under the Roman empire, only for them both to dissolve into a myriad of entities forced into self-subsistence and plagued by perpetual conflict, subsiding into what Dante called the 'etadi grosse' (the dark ages)[20] and centuries of economic (and civic) regression. It would probably not be too difficult to find other examples in the distant past.

Closer to our own time, there is a famous piece written by Keynes in 1919, quite familiar at least to economists (the entire passage need not be cited here). In the early twentieth century, he wrote, an 'inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble,

19 R. Rajan (2022) cit. [link to IMF publication: https://www.imf.org/-/media/AMSM/Files/AM2022/Seminars/per-jacobsson-lecture-october-2022.ashx]

20 Dante, *Purgatory*, XI, 93

in their prospective fruits and advantages'.[21] Keynes was describing a state of affairs not unlike the one to which we have become accustomed over the past few decades of hyperglobalisation, though this was a completely different state of affairs to the one that was about to unfold while Keynes was writing, with unprecedented, ominous clouds gathering over the skies of international cooperation. The dark ages that soon emerged, though for a shorter spell than the high middle ages, need not be mentioned.

The reconstruction that began at end of the Second World War was based on and inspired by international cooperation. Those were the founding years of the International Monetary Fund, the World Bank and the United Nations, launching a phase of gradual opening up and growing prosperity that would continue for over six decades. Let us hope that humankind has learnt this positive lesson.

[21] The quotation finishes as follows: 'or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend'. (J.M. Keynes, *The Economic Consequences of the Peace*, 1919).

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