Populism and the threat to globalisation

One of the distinguishing features of the global economy since the oil price shocks of the 1970s has been the rapid growth in the exchange of goods, capital and information across national borders.

This latest era of globalisation, dubbed the ‘second unbundling’ by British economist Richard Baldwin, has helped to lift global wealth as well as reduce global poverty, but it has also coincided with increased income inequality. The rise of populist parties in Europe, the Brexit vote and the election of President Trump in the United States have all been linked to the widespread public perception that globalisation has been the driving force behind adverse distributional trends.

Our own perspective is more nuanced. We argue that the rise of populism is a symptom of deeper social, political and economic changes that are only partly due to globalisation. Nevertheless, the current political trend does represent a threat to the policy consensus that has supported trade, financial and domestic market liberalisation over recent decades.

Governments must therefore find a way to reconcile open markets with more stable and broadly distributed economic growth, as well as greater democratic accountability for transnational institutions – otherwise globalisation will be challenged. That would be a threat not only to global growth but also to the return on risk assets given the supporting role globalisation has played in the secular rise of the corporate profit share of GDP.

In this paper, we outline the markers that have defined the latest era of globalisation and its influence on global and national income trends. We then address the distributional consequences of globalisation – both actual and perceived – and how they have influenced the rise of populist political movements. We end by considering the outlook for globalisation and some investment implications.
Global trade and global growth

To what extent has the economic success of the last two generations been driven by globalisation?

Global trade barriers have been trending lower since the signing of the General Agreement on Tariffs and Trade (GATT) in 1948 (see Chart 1). This United Nations initiative saw 23 countries sign up to an agreement to reduce tariffs and other barriers to trade. A series of further rounds of multilateral negotiations led to an increase in both the number of countries included and the range of goods covered, while many countries also pursued unilateral trade liberalisation in an effort to bolster growth after the oil shocks of the 1970s.

The formation of the World Trade Organisation (WTO) in 1995 marked a step-change in the management of global trade. 134 countries signed up to an agreement that not only covered tariffs, but also non-tariff barriers, agricultural subsidies, intellectual property rights and a greater proportion of trade in services. The organisation was also created to act as a policeman, setting the international rules for trade and handling disputes.

The creation of the WTO represented the high water mark for multilateral trade liberalisation. Subsequent WTO negotiations made more limited progress, incentivising a boom in the negotiation of a web of regional and bilateral trade agreements that have further lowered aggregate barriers to trade, but also diverted trade from non-participating countries and increased the complexity of the global trading system.

One marker of this second unbundling is the decline in the world average goods tariff rate, from close to 10% at the start of the 1980s to below 5% today. However, the reduction in tariff and non-tariff barriers to goods trade is only one part of the story of globalisation. Barriers to services trade have gradually declined amid efforts to harmonise national regulations. Technological advances like the internet have lowered the costs of trade while also facilitating greater information and knowledge transfers across borders. Financial deregulation in the years before the financial crisis helped fuel a massive expansion in both financial and non-financial balance sheets, as well as the rapid growth of international capital flows.

Chart 1: Global trade barriers

Source: Daniel Gros (2016), Clemens and Williamson (2004), WTO database
Regulatory barriers to economic activity have been cut in the domestic realm too, especially in the advanced economies. Product market regulations have been loosened substantially. Previously state-owned assets in strategic industries like airlines, rail, telecommunications and energy have been privatised. And labour markets have become more flexible, both through deregulation and a reduction in the role of unions. In most sectors of the economy, firms and workers are more subject to the vagaries of market forces than ever before.

An especially important aspect of modern globalisation has been the creation of global supply chains. Far from the textbook model of countries trading completely different goods on the basis of their comparative advantage, a large and rising proportion of global trade happens within industries – and even within firms – as complex manufactured goods incorporate intermediate components from across the world. This means that gross trade data do not capture the whole story as each country’s exports embed the value-added of each country involved along the chain.

Numerous studies have demonstrated the positive contribution of globalisation, across all of its dimensions, to the secular upward trend in aggregate global activity and living standards. However, demographic, technological and institutional factors have also been important. In most of the advanced economies, women account for a much larger portion of economic contribution to market activity. Emerging market economies have seen a steady migration of underutilised rural workers to more productive and internationalised cities. Education levels have been on a steady upward trajectory in most economies. Domestic and international institutions have generally been strengthened, with the rule of law more widely applicable, corruption levels lower, and monetary and fiscal policies wielded less arbitrarily.

Of course, changes have not just been economic, they have also been cultural. When the G6 met for the first time in 1975 to discuss the big global issues of the day, it was an all-male affair and the other global leaders watching events from afar included large numbers of military dictators and communists. Today’s G20 meetings are a more diverse bunch in terms of race and gender, though they are all part of the cosmopolitan ‘Davos set’ and their values are often closer to each other than to those of their fellow countrymen. Meanwhile, the democratisation of travel and the globalisation of knowledge and ideas have helped spread liberal values surrounding race, gender, religious tolerance and other aspects of individual freedom.

**Chart 2: Winners and losers**

![Global growth incidence curve, 1988-2008](chart2.png)

Source: Milanovic & Lakner (as of 2014)
The paradox of inequality

Our era of globalisation has been associated with a dramatic decline in global poverty. In 1990, 35% of the world’s population was living on less than $1.90 a day; today that proportion is only a little above 10%. This is an enormous achievement and should be celebrated.

However, the benefits of rising economic activity have not been equally shared. The famous “elephant chart” (Chart 2 on previous page), from a study by Branko Milanovic and Christoph Lakner, captures the relative winners and losers. The horizontal axis shows the percentiles of global income distribution, from the poorest people in the world on the left hand side to the richest on the right. The vertical axis shows the growth in real income between 1988 and 2008, the period roughly between the fall of the Berlin Wall and the global financial crisis.

There have been two sets of relative winners and two sets of relative losers. The biggest winners have been those around the median of the global distribution of income. These include the factory workers and their families in the countries that benefited most from the dramatic reorientation of manufacturing activity from the advanced economies to the emerging economies, particularly China and the other east-Asian economies (see Chart 3).

The other winners have been the owners of capital and the very best paid, the so-called ‘one percent’, located mostly in the advanced economies. Not only has the income share of the top 1% increased substantially but they now own over 50% of global wealth according to the Credit Suisse Research Institute Global Wealth Report (2016). The return on capital has exceeded the rate of growth in the economy over the last 20 years. Highly skilled workers have benefited too, as their expertise is typically complementary to both technological change and globalisation.

One set of losers has been the world’s poorest, who mostly reside in countries isolated from the benefits of a more globalised world and where warfare, institutional failure and corruption act as an enormous drag on economic development. The other set of losers have been the semi-skilled lower and middle-income workers in the advanced economies, who have either lost their jobs outright, or seen their wages eroded by the treble forces of technological change, domestic deregulation and globalisation.

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Explaining the rise of populism in the west

The sheer size of the reduction in absolute global poverty levels, combined with the very weak income growth of the western middle class, means that global income inequality, including between nations, has declined during the era of globalisation. But at a local level, income inequality has increased almost everywhere, and politics is almost always local.

The most comprehensive cross-country research on the underlying causes of these increases has been conducted by the IMF. That research suggests that globalisation has made almost no contribution to rising inequality in the emerging world, helping to explain why there has been little backlash against trade liberalisation in these countries.

In the advanced economies, the story is more complex. Although globalisation has not been the biggest contributor to higher inequality – greater labour market flexibility, the deepening of financial markets and skill-based technological advances have jointly been more important – globalisation has played a larger role than had earlier been acknowledged by economists. Indeed, the latest research suggests that competition from China may have persistently lowered employment rates in the most exposed American communities. Even more important for political trends has been the popular perception that globalisation has been the driving force behind the hollowing out of the middle class (see Chart 4) and, in politics, perception can matter more than the reality.

Chart 4: The hollowing out of middle class jobs

![Chart showing percentage change in employment shares for low-, middle- and high-paying third jobs across various countries.](chart.png)

Source: Gross, Manning and Salomons, 2009a – referenced by Autor 2010
Until the financial crisis, the common view among policymakers and establishment politicians was that increased inequality was an acceptable price to be paid for stronger economic growth. Those that doubted this logic were mostly pushed to the fringes of political and policy debates. And though globalisation was not exactly loved by the bulk of the voting population, it was rarely a prominent election issue either.

The financial crisis and its aftermath have shattered that consensus. Not only had the rising tide not lifted all boats in the years before the crisis, but the tide was no longer rising. Sub-prime borrowers lost their houses, workers lost their jobs, while banks were bailed out. The slowdown in economic growth since the crisis has meant that many voters in the developed world have seen real wages stagnate or even fall (see Chart 5). And though unemployment rates have declined in many places, there are few places where employment rates have returned to their pre-crisis levels. For many of those that have found jobs, they are often not the jobs they want and have come with a pay cut.

![Chart 5: UK real wage growth since 1770](image)

Source: Resolution Foundation, 2017. Change in average pay between last 10 years and 10 years before (CPI and predecessors-adjusted)
The financial crisis, combined with the structural changes in the composition and distribution of economic activity in the decades beforehand, as well as rapid change in the social and demographic structure of many western societies, has created a perfect storm for a rise in populist parties and politics (see Chart 6). Electorates across the advanced economies are becoming more fragmented and increasingly seeking alternatives to mainstream centrist parties. Even where centrist parties have survived, they have often chosen to ape the policies of their populist rivals, and had more difficulty building effective governing coalitions and legislating policy.

The upshot is that policy uncertainty has increased, which in turn has had meaningful effects on economic and market activity. Polling has also become less accurate, increasing political risk for investors. We set out our analytical framework for assessing the drivers of political risk, together with the implications of the series of elections in Europe this year, in our recent Global Horizons paper: What makes politics tick? Understanding political risk in markets.

It bears repeating that the causes of the rise in populism are not just economic. The impact of cultural shifts over last two generations was particularly apparent in the recent US election. Trump won over 70% of the two-party vote among whites without a college degree, amid a very high turnout among those same groups. While white voters with negative perceptions of the economy and their own prospects were more likely to vote for President Trump, attitudes to sexism and racism were also strongly predictive. Arguably, no group has seen a greater loss of relative economic and social status over the past few decades. Similar forces were at play in the UK’s vote on EU membership, as well as recent European elections.

Chart 6: Share of vote for populist parties
The future for globalisation, populism, economies and markets

Some of the biggest questions facing investors are where the rise in populism will lead and whether globalisation could even reverse.

The example of the period between World War I and World War II suggests that it is possible. While globalisation is popularly understood as a relatively recent phenomenon, we are actually in the second era of globalisation. In the 19th century, world trade is estimated to have risen by 4% per annum. By the mid-1870s average tariffs stood at low single digits in Britain, Germany, Netherlands, Sweden and Switzerland. Capital flowed relatively freely around the world, aided by a global monetary system – the gold standard. Labour mobility exceeded today's levels despite the significant barriers to travel. Ominously, that era of globalisation was also associated with substantial rises in inequality.

This trend came to an abrupt halt in 1914, with the outbreak of World War 1 and the deep European recessions that followed it. The United States fared better during the 1920s but the 1929 stock market crash and subsequent depression led to the imposition of some of the highest tariffs in history in 1930; the infamous Smoot-Hawley act. This triggered reciprocal retaliation around the world and contributed to a halving of trade volumes between 1929 and 1937. This was part of the economic backdrop to World War II. It was this 30 years of turmoil that provided the impetus to put in place the World Bank, the Bretton Woods agreement and the other economic and political institutions that allowed globalisation to recommence.

Today, globalisation appears to be under threat and, like the interwar period, the trigger has been an economic and financial crisis against the backdrop of earlier rises in inequality. Globalisation was slowing even before Trump's election. The responsiveness of global trade to global GDP growth had fallen significantly. New trade agreements had slowed to a trickle in recent years. Protectionist trade measures had started to outnumber trade facilitation measures amid more disputes at the WTO. One of the first acts of President Trump was to pull out of the Trans-Pacific Partnership, a 12-nation trade deal that was meant to reignite trade liberalisation in Asia and set the example for a similar US-European pact. Britain has triggered its exit from the European Union (EU), which has led to a call for a second referendum on Scottish independence. Marine le Pen's National Front party in France is also advocating an exit from the Eurozone. They are not expected to win this year's elections, but then neither were President Trump nor the UK leave campaigners. Nor do they need to win to influence policy.

There are grounds for optimism that a full reversal will not take place. The lessons of the interwar years are well understood in policy circles. The existence of global supply chains render tariffs especially unattractive. WTO rules are still in place and most countries are abiding by them. China is the world's second largest economy and has signalled that it intends to take the lead on Asian trade liberalisation, though its reluctance to open its own market to domestic and international competition means that progress will be slow. Some of the decline in global trade growth over recent years can be explained by cyclical factors rather than a retreat from globalisation. Meanwhile, technological advances will continue to break down barriers to trade, even if policy factors are working in the other direction.
However, it is hard to see globalisation reaccelerating. The major gains from the liberalisation of trade in goods have largely been had. The next wave of globalisation will need to come in services and investment, but there the rules are less well defined and the implications highly political. It is also telling that few western leaders are prepared to make the case for further liberalisation. We will be taking up the question of the future of globalisation in much more detail in an upcoming Global Horizons.

There is also little reason to expect a near-term reversal in the trend towards populism. Many of the social and economic trends that have driven this political shift are expected to continue. Even if globalisation continues to slow, the technological trends that favour the 1%, such as the increasing use of robots and artificial intelligence, remain in place, maintaining the pressure on middle income workers. This is happening at a time when demographic and productivity trends are already weighing on growth.

Populism is not a solution to these ills. Indeed, a reversal in globalisation would almost certainly weigh on economic and productivity growth (see Chart 7). But if liberal values and open markets are to survive, policy will need to adapt. The challenge is to marry open markets with more stable, evenly distributed growth and greater democratic accountability. Economists have always known that globalisation creates winners and losers but the losers are meant to be compensated and retrained. Too often they have not been. Globalisation and less regulated domestic markets also leave workers more vulnerable to economic fluctuations. Yet policy changes over recent decades have tended to reinforce, rather than reduce, that vulnerability.

![Chart 7: Growth in global labour productivity and trade volume](source)

Source: World Bank, The Total Economy Database (Nov 2016), IMF World Economic Outlook
There is also a lot at stake for investors, who have become used to corporate profits growing faster than GDP and have set their long-term return expectations accordingly (see Chart 8). Globalisation has not been the only driver of this trend but it has made an important contribution nonetheless. Yet an ever-increasing share of the pie for corporates, and their shareholders, at the expense of workers is also unsustainable. Recent evidence shows that increased inequality is detrimental rather than accretive to economic growth. It also corrodes the body politic and undermines social cohesion.

Governments and people’s representatives must respond by transforming education, tax and transfer systems so that workers can adapt better to changing market circumstances, get the support they need when times are bad, and share in more of the gains when times are good. They can also do more to ensure that transnational institutions become more transparent, accountable and responsive to local needs, while also setting an example through their own behaviour to help rebuild trust in political institutions. As a society, we must aim to put in place the policies that will sustain the benefits of a more globalised world. But as investors, we must also be prepared for the risks of a more negative outcome.

**Chart 8: US corporate profits as % of GDP**

Source: Datastream, BEA (2017)
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