

GLOBALISATION OUTLOOK

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October 2018



SUMMARY

- In this issue we argue that to understand the dynamics of the current trade conflict, we need to look at it through a political as well as an economic lens
- Apart from the economic gains, trade has always been an instrument to project geo-political power. Achieved either by defining the terms of trade or by using tools of trade explicitly to achieve geo-political objectives.
- The West's belief that increased trade will inexorably lead to democratization has proven to be over-optimistic
- We believe that the pattern of opportunity and risk in trans-national trade will continue to change substantially – and will be largely driven by political rather than economic factors
- The main challenge will be how to preserve and manage a liberalised trading system as the Chinese model of political economy has started to provide an alternative to the previously dominant Western market-driven model
- As China rises to a major geo-political power, we should be thankful if its conflict with the US remains restricted to skirmishes around international trade when most previous transfers of power have ended in armed conflict

We need to look at the current trade conflicts through political as well as economic lenses

TRADE WARS – WISDOM OR FOLLY

As the current trade conflict heats up, some economists and business leaders express dismay and incomprehension at what is happening. We are bombarded by endless column inches on the economic benefits of liberalized trade, the misguided nature of increased tariffs and the economic damage that will arise for all concerned if things are allowed to escalate.

All these warnings are reasonable. Yet, it feels as though the column inches represent nothing more than wasted space as the US ramps up its tariffs, others retaliate, and a number of countries, including Germany, the UK, Australia and others have started to question and block cross-border investment and takeovers by overseas, particularly Chinese, investors. Economists and advocates of liberalized trade are starting to tear their hair out. While there is growing support for investment restrictions, tariffs continue to be implemented (with India now joining the tariff war) even as economists suggest that they may well be counter-productive.

One reason for the bewilderment is that critics may be looking at the evolving conflict through too narrow a lens – the lens of economics and corporate profits. The reality is that trade has always been about more than that. Trade is, and has always been, about extending power and influence; and power has always been about setting the rules of trade. Countries have engaged in trade when they believed that collaboration with others provided them with advantage – economic and political – that it could provide access to goods and services not domestically available, and that they could shape the rules of such collaboration largely to their advantage.

Understanding the current trade conflict therefore requires looking at it through a political lens as well as an economic one.

Trade is an instrument of foreign and domestic politics

THE GEO-POLITICS OF TRADE

As we take pains to point out in our recent book, trade has always been a matter of political economy. In other words, understanding trade, and trade conflicts, depends on understanding the changing geo-political landscape and interpreting actions in that context.

Trade is an instrument of foreign and domestic politics – whether it's designed to increase the prosperity of the local populations as a part of domestic policy; or whether it is designed to project political power overseas.

Hence, for instance, the almost constant application of trade sanctions to force political change – as we saw at the time of apartheid South Africa and

as we are seeing with Russian sanctions following the annexation of Crimea and the conflict in the Donbass. The box below lists, in no particular order, a few of the instances when the relationship between trade and the achievement of political objectives becomes explicit.

In many cases, the political objectives of trade agreements and trade sanctions become very explicit

Politics and Trade

- US and European countries start seeing China imports and investments as a threat to national security
- China's Belt and Road initiative seen as new form of economic colonialism
- The sovereignty of energy dependence becomes a source of dispute
- Saudi Arabia freezing all new trade and investment relationships with Canada because of its criticism of the Saudi regime
- EU uses promise of increased trade relations to encourage democratization in Ukraine
- Western countries impose trade sanctions on Russia following Crimea annexation
- Trade a crucial element in relations (or non-relations) with North Korea
- Long-standing Iran sanctions partially lifted following JCPOA. More sanctions re-imposed following US withdrawal from the agreement. Europe revives blocking statutes and requires European companies to seek EC approval before withdrawing from Iran
- Philippines President Duterte promises to 'shut up' about Chinese occupation of South China Sea islands in return for more trade
- Greece vetoes European statement criticizing China's human rights record following Chinese acquisition of the port of Piraeus
- China pushes Vietnam to stop Spanish company Repsol from drilling in its waters

THE CHANGING LANDSCAPE

The projection of power lies in the ability to shape the rules of trade to one's own advantage

An important element in the projection of power lies in the ability to set the rules under which international trade operates.

The tail end of the 20th century was characterized by Western supremacy and, within that, the unchallenged position of the US as the world's only superpower; and a belief in the superiority of the Western combination of liberal democracy and the market oriented model of economic development. The West – and largely the US – were in a position to set the rules of world trade; and they did so to favour their own model of political economy.

China's admission to the World Trade Organisation (WTO) was seen as a continuation of this global destiny. Welcoming China, President Clinton pronounced:

"China is...agreeing to import...economic freedom"

President Bill Clinton

"By joining the WTO, China is not simply agreeing to import more of our products, it is agreeing to import one of democracy's most cherished values, economic freedom. When individuals have the power not just to dream, but to realize their dreams, they will demand a greater say."

Embarking on trade with China was thus presented as part of the progress of China to an open market economy and, it was hoped, eventual democratization. After all, the WTO rules had been set by the West based on its model of political economy. Anyone who joined was therefore agreeing to being bound by Western (largely US-driven) rules. It was assumed that the US would be the biggest beneficiary of any trade system driven by a set of rules it had largely set.

This framing was believed by many and also served to blunt criticism of doing business with a harsh, authoritarian regime.

IT DIDN'T QUITE WORK OUT THAT WAY

Now we know that this framing was unduly optimistic – some would say hubristic.

China is nipping at the US heels without bending to Western rules

China has benefited from its admission to the WTO to propel its economy to become the second largest in the world, nipping at the heels of the US. While it has opened its markets significantly since WTO admission, in aspects like intellectual property protection, state direction of the economy and state support for its corporations, it has not bent to Western rules. Neither is there any evidence of progress towards democratisation. In fact, recent

crackdowns suggest a move away from democratisation – maybe a reaction to unrest caused by increasing prosperity.

When models of political economy differ fundamentally, the effectiveness of multilateral institutions breaks down

A growing Chinese economy has allowed the country to build its military might as well as becoming a serious challenger in the new economy. Its Belt and Road Initiative and extensive (some would say reckless) overseas investments have become a tool to project power.

In addition, China and others now provide a competing model of political economy. The WTO system worked well when it was assumed that a single model would be shared by all. When rivalry is between two comparable models of economic development, (eg. the US and the EU) it can be managed through shared rules and institutions. However, when models differ fundamentally, the effectiveness of institutions breaks down and the economics of trade become enveloped in the ensuing ideological struggle.

THE US RESPONSE

The US remains, today, the world's most powerful country. The largest economy, the most advanced military power, holding a significant ability to project soft power (only exceeded in this last respect by the UK, France and Germanyⁱ), and holding the world's reserve currency.

But it is also becoming obvious that such dominance cannot be taken for granted, nor that it will last forever. It is therefore perfectly understandable that the US would choose to force a change in the rules of the game now, before its relative power is eroded further.

It might be reasonable to ask: if the problem is China, why also take on NAFTA and the EU?

The US no longer sees multilateralism as being in its own best interests

The US Administration seems to have concluded that, in the new world, multilateralism no longer serves US interests best. It is working towards a bilateral system where it can use its superior power to its advantage unhindered by having to balance multiple interests in international forums. If it can show that such an approach works with Mexico, Canada and the EU, then it will be in a much better position for the inevitable show-down with China.

So far, this approach seems to be working. The US is a much more domestically focused economy than many others. The Bank for International Settlements estimates that a complete revocation of NAFTA would cause a 2.2% decline in Canada's GDP, a 1.8% fall in Mexican GDP, and a mere 0.22% fall in U.S. GDP.

President Trump may not be totally wrong when he claims that ‘trade wars are easy to win’ – for the US.

INVESTMENT

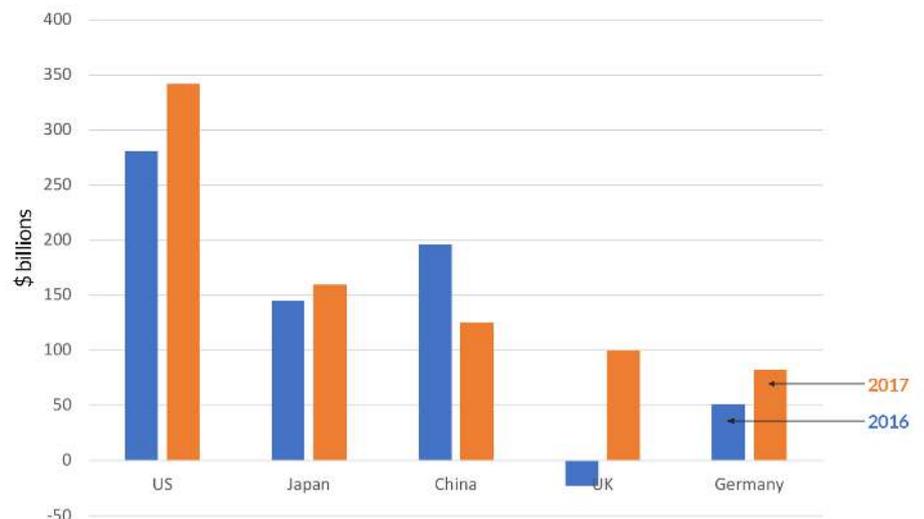
Trade, is, of course, not the only area of competition. Overseas investment is another way of projecting power.

The US still remains the biggest overseas investor (figure), with China showing a drop in 2017 relative to 2016.

The US is moving to boost government-directed overseas investment to project power

However, one key difference is that China’s state directed economy is, as we outlined in our previous newsletter, able to use its overseas investments strategically (and, some would say, at great financial risk) while in free-market economies these investments are all driven by large numbers of individual company decisions without any form of co-ordination. Which is why the US is intent has just earmarked \$60 billion for its Overseas Private Investment Corporation, a government agency that, until recently, was on the block for possible elimination.

The US maintains the largest outflows in Foreign Direct Investment



Source: UNCTAD World Investment Report 2018

How will the IMF handle countries who run into financial trouble due to Chinese debt-funded infrastructure projects?

The US is also seeking clarification from the IMF as to how it will deal with countries that run into financial trouble because of Chinese debt-funded infrastructure projects. Senators have written to the Treasury Secretary and the Secretary of State asking a bunch of questions, among them: “As the largest contributor to the IMF, how can the United States use its influence to

ensure that bailout terms prevent the continuation of ongoing BRI [Belt and Road Initiative] projects, or the start of new BRI projects?"

DO TRADE AND OPEN MARKETS LEAD TO DEMOCRATISATION?

"When individuals have the power not just to dream, but to realize their dreams, they will demand a greater say."

...according to President Clinton.

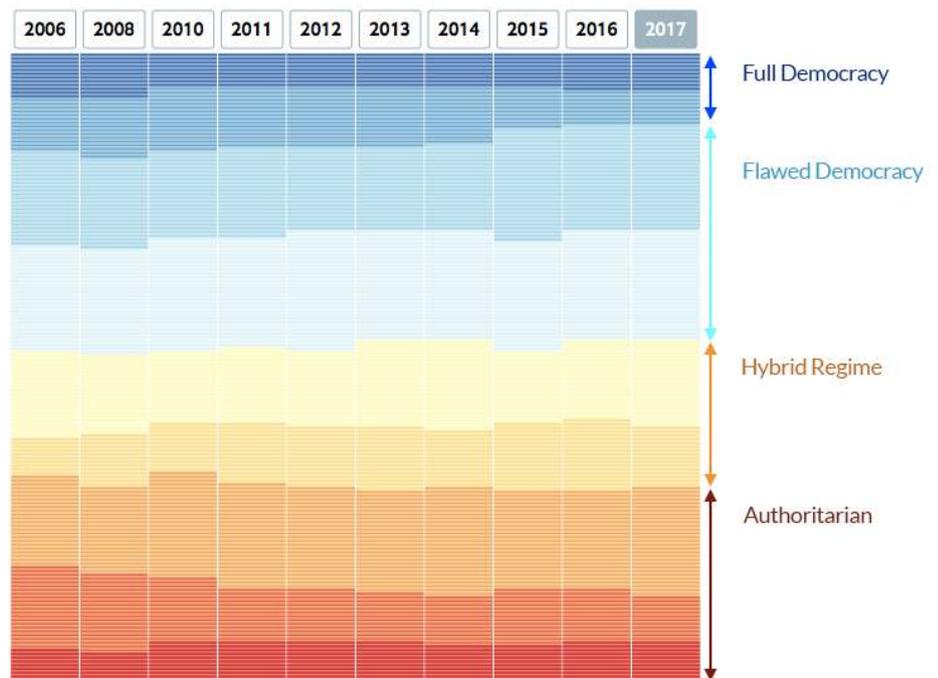
Which raises the question: do open markets and liberalised trade lead to democratization?

The reality is that full democracy is to be found only in a small minority of countries across the world. Over the last decades, when we have seen an inexorable rise in international trade flows, democracy does not seem to be on the increase. It seems more like being in retreat. (figure).

The reality is that establishing truly democratic structures in countries that have not had such traditions is a hard an arduous process. It is simplistic to believe that increased trade flows will inexorably lead to democracy. Just like 20th century 'nation building' through armed intervention has largely failed to build solid democracies in places like Iraq and Afghanistan.

In spite of increased trade, democratic governance is in retreat

Democratic governance is limited and shrinking



Source: Economist Intelligence Unit

CONCLUSIONS

As the power balance changes, we should be thankful if the US-China conflict remains restricted to trade

The past 500 years have seen 16 cases in which a rising power threatened to displace a ruling one. Twelve of these ended in warⁱⁱ.

In that context, we should be thankful if the power struggle between the US and China is fought over trade and investment rather than escalation to military conflict.

We reach the following overall conclusions:

- The current trade and investment conflict still has a long way to run
- It will involve a number of countries and blocs not just the US and China
- Developing a new multilateral system that can comfortably accommodate widely different models of political economy will be challenging. There is no previous experience on which this can be based
- If the US continues to believe that bilateralism serves its interests best, a new multilateral model may fail to emerge
- It is probable that global supply chains will not remain as smooth and uninterrupted as they have been in the past. In the digital realm, we expect increasing Balkanisation of data and increasing suspicion of digital components coming out of some countries
- New opportunities may arise for overseas investment by Western businesses due to an increased emphasis on direct challenge to China's Belt and Road Initiative
- We still believe that, overall, there are and will continue to be considerable opportunity in trans-national trade. However, the pattern of opportunity and risk will likely change substantially
- Businesses that operate trans-nationally need to ensure that their future plans are based on an understanding of the dynamics (and the uncertainties) of geo-political change.

The pattern of opportunity and risk in trans-national trade will continue to change substantially

References

ⁱ Soft Power 30, 2018.

ⁱⁱ Graham Allison. The Thucydides Trap. Foreign Policy, June 9, 2017