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ESSAY

# The World Will Regret Its Retreat From Globalization

**Trade and financial flows have fallen well below their peaks, and poorer countries will bear the brunt.**

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Globalization was meant to bring the world closer together, enmeshing advanced and developing economies in a web of mutually beneficial economic and financial linkages. From about the mid-1980s, trade and financial flows between countries expanded rapidly as governments dismantled barriers to these flows.

Not everything went according to plan. Tensions rose as the benefits were not equally shared within or among countries. Widening economic inequality, often attributed to free trade, roiled many advanced economies and has had far-reaching political consequences. While they benefited from access to foreign markets for their exports, many emerging market countries were ravaged by volatile capital flows and the fickleness of international investors. Still, there was a broad consensus that shared economic interests would ultimately triumph and even help smooth over geopolitical frictions.

This script held up well through the mid-2000s. Over the last decade and a half, a series of shockwaves has shredded the script. These include the 2008-09 global financial crisis, the COVID-19 pandemic, and various geopolitical ructions, such as rising U.S.-China tensions and the Russian invasion of Ukraine. Worldwide trade and financial flows have fallen well below their peaks.

While economic factors account for much of this decline, industrial policies in various guises are spurring the shift toward weaker global trade and financial integration. China's "dual circulation" policy, for instance, involves a state-led focus on increasing self-reliance (by boosting domestic demand and indigenous innovation) while remaining engaged with the global economy. The "Make in India" initiative has similar objectives of boosting Indian manufacturing

by protecting domestic manufacturers in specific sectors from foreign competition. Even advanced economies, once seen as unabashed proponents of free trade, are joining the bandwagon. The Biden administration's Inflation Reduction Act aims to boost green technologies by deploying subsidies and tax breaks to incentivize the domestic production of electric vehicles and renewable energy components. The CHIPS and Science Act provides similar incentives to semiconductor firms to set up manufacturing facilities in the United States and bans outsourcing to "China and other countries of concern."

As countries retreat from globalization and begin to look increasingly inward, there could be wide-ranging implications for both economic and geopolitical stability. Just as with the surge in globalization, however, the consequences of this pullback are proving to be unevenly distributed, with low- and middle-income countries bearing the brunt.

During the era of globalization, trade and financial flows around the world were driven mainly by economic considerations. With transportation costs falling, corporations in advanced economies found that they could take advantage of lower labor costs in developing countries. Moreover, they were able to structure lean and efficient supply chains that threaded through multiple countries, enabling cost savings by relying on different countries' specialization in various intermediate products. To this day, iPhones and MacBooks have electronics and other components sourced from multiple Asian countries, with the final stages of production mostly being handled in China.

Foreign direct investment (FDI) flows have tended to follow trade, with corporations setting up operations abroad and investing in manufacturers as well as suppliers of various kinds of inputs, including raw materials and intermediate goods. Emerging market countries, which had for a long time been able to get foreign financing only in the form of debt and at unfavorable terms, were now receiving more stable flows and at better terms that did not require them to assume all the risk. Direct investment tends to be less volatile than debt or other forms of financing, and foreign investors share in the risks of such investment in return for prospects of better returns.

Financial flows ran both ways, with many emerging market countries using their trade surpluses to accumulate rainy day funds and invest them in government bonds issued by the United States and other advanced economies. This way, if and when foreign investors turned their backs on an emerging market country that had been in their favor, that country would still be able to pay for its imports in hard currencies and protect the value of its own currency. A symbiotic relationship developed between advanced and emerging market countries, with both groups profiting from relatively unfettered trade and financial flows.

Emerging market countries benefited from globalization in multiple ways. They were able to expand markets for their products beyond their national borders, allowing them to build strong manufacturing sectors and robust middle classes. Trade relationships with advanced economies and their more sophisticated corporations facilitated transfers of technology as well as state-of-the-art production processes and managerial practices. As a result, many companies in emerging market countries became large and modern enough that they were able to compete toe-to-toe with their advanced economy counterparts, engendering more competition, innovation, and benefits for consumers worldwide.

Foreign investment played a similar role, as corporations had an incentive to ensure that their suppliers in emerging market countries were operating with the best technological and managerial practices. Foreign funds even helped in creating more robust financial markets with larger trading volumes and better regulation. Domestic financial market development in fact came to be seen as a key “collateral benefit” of globalization, as it allowed emerging market countries to channel not just foreign funds but even domestic savings to more productive investments.

Cross-border financial flows fell after the global financial crisis, mainly as a result of Western banks reining in their global aspirations, while trade flows continued to expand. For both types of flows, economic considerations such as efficiency and cost minimization remained front and center in determining their patterns. It seemed just a matter of time before financial flows, or at least FDI flows, would also return to pre-crisis levels.

**Then the world changed.** The COVID-19 pandemic disrupted supply chains worldwide. With various countries affected at different times and with varying intensities, this worsened the pandemic-induced recession as one broken link could disrupt the entire chain. China’s zero-COVID strategy wreaked further havoc on global supply chains. Corporations that had touted the efficiency of their supply chains were left adrift as those became points of vulnerability. The pandemic accentuated other fragilities that had already been brewing in the background. Geopolitics took a turn for the worse, with rising tensions between the United States and China exacerbating these problems. Russia’s invasion of Ukraine showed that relying on a single supplier of energy products could leave an entire continent vulnerable.

National governments and corporate leaders have taken note. There is change in the air and on the ground as they adapt to difficult new realities. Trade tensions, geopolitical fractures, and efforts to combat climate change are shifting the focus away from efficiency, typified by lean and mean supply chains, toward stability and resilience. One way to deal with uncertainty is through diversification of supply sources and export markets for goods and services. Apple, for instance, is trying to switch some of its production and assembly to India and Vietnam. But diversification is typically costly and adds complications of a different sort, including having to manage multiple supply chains.

Instead, countries and corporations are taking a different tack, redirecting their trade and financial flows to align with geopolitical commitments. Such responses include trade measures (tariffs as well as import and export restrictions) but also industrial policies to promote domestic technologies—policies that effectively act as trade and investment barriers. Governments of all stripes feel a need to stimulate investment in new technologies, especially green technologies. For emerging market economies—especially countries with unfavorable demographic trends, such as China—such investment is viewed as essential to keeping economic growth from declining precipitously. For advanced economies facing rising competition from emerging markets, such investment is seen as existential for their shrinking manufacturing sectors.

Supply chain disruptions, geopolitical fragmentation, adaptation to climate change, and a host of economic and political pressures are thus all pushing in the same direction, toward an inward tilt of economic policymaking. In the guise of preserving U.S. technological supremacy, improving

energy security, and promoting domestic investment in green and other new technologies, the Inflation Reduction Act has put in place a number of policies that implicitly serve as barriers to free trade, such as tax credits for electric vehicles made in the United States.

Private corporations are also causing a pullback from globalization, with reshoring and friendshoring having become their *mots du jour*. Reshoring involves moving a good's entire production process back within the borders of the home country; friendshoring involves threading supply chains only through countries that are seen as geopolitical allies to eliminate the threat of disruption as a result of geopolitical tensions.

Globalization is not dead, but it has clearly taken a turn toward fragmentation along geopolitical lines, which could have important economic consequences for all countries. Patterns of both trade and FDI flows are gradually shifting in ways that mirror geopolitical alliances. Emerging market economies, which have in many ways benefited from global trade and financial flows but also been subject to globalization's whiplash effects, now stand to suffer the adverse effects.

For emerging market economies not politically aligned with advanced economies, lower trade and financial flows will mean fewer technology and knowledge transfers, hindering their path to development. With countries pulling back from global integration, access to export markets could also become more constrained over time. This might matter less for countries such as China, India, and Brazil—which have grown large, more self-sufficient, and richer than many other emerging market economies—but could stifle those countries that are smaller and still at earlier stages of economic development.

These trends will hamper the economic development of low-income countries, many of which have the advantage of relatively young and expanding labor forces but remain bereft of financial and other resources. Low-income countries in sub-Saharan Africa, in particular, lack the financial capital and technological know-how to build basic manufacturing, let alone compete effectively in the industries of the future. Limited foreign investment, especially in manufacturing rather than just resource-extraction industries, and restrictions on access to global markets for their goods will make it even harder for these countries to attain economic progress and improved standards of living for their populations.

**It's possible that the magnitude of financial flows** to emerging markets will essentially remain the same. Advanced economies are beset by aging populations, high levels of public debt, and low productivity growth. For investors looking for better returns on their investments or, at a minimum, diversification opportunities, emerging market economies are likely to remain attractive. But the nature of that financing could change in important ways. Rather than more stable flows such as FDI, emerging markets might receive more of this funding in the form of portfolio investment—money flowing into equity and corporate debt markets—that is still welcome but tends to be volatile. These flows also tend to bring with them fewer collateral benefits such as technology transfers.

Many low-income African countries are becoming increasingly indebted to foreign creditors, both private and official, who provide them with foreign currency loans that are inherently riskier for borrowing countries. Meanwhile, direct investment flows to much of the region have

leveled off in recent years. These countries typically have low levels of foreign exchange reserves, leaving them vulnerable to the whims of their creditors.

The restricted patterns of trade represented by reshoring and friendshoring, which are intended to lower volatility, could also increase rather than decrease vulnerability to certain types of adverse events. Climate change is, after all, becoming a greater risk that transcends economic and geopolitical frictions among countries. In 2011, floods in Thailand brought global supply chains for automobiles and certain electronic products to a grinding halt because the country was a manufacturing base for certain types of electronic chips. Regional concentration could make supply chains more vulnerable to such climate-related events.

There are other costs as well. As economic flows come to closely parallel geopolitical alignments, an important counterweight to geopolitical frictions is being eroded. Take the complicated U.S.-China relationship, which has become increasingly fraught as China's rising economic might puts the two superpowers in direct competition on multiple fronts.

The economic and financial relationship between the two countries once served as a counterweight to geopolitical tensions. After all, such a relationship can be constructed and maintained in a way that benefits both countries, making it a positive-sum game. By contrast, geopolitical influence is inherently a zero-sum game, with one country's rising influence coming at the expense of its rival.

The evolution of the U.S.-China relationship is a precursor for how even economic relationships have come to be seen as a zero-sum game. China's aspirations to ascend from middle-income status to the ranks of rich economies will require an upgrade of its industrial structure and a shift from low-wage, low-skill manufacturing to higher-productivity firms that are at the frontiers of technology. Indeed, technology has become the new battleground, with China aiming for self-sufficiency and looking to increase its global market share for high-tech products and the United States seeing a threat to its commercial interests as well as national security as Chinese companies increase their global footprint. The United States has restricted exports of high-tech products and technologies and even tried to dissuade private investment from flowing to China. Trade and economic tensions between the two countries are now feeding into and heightening political tensions.

Thus, and somewhat ironically, fragmentation of trade and finance along geopolitical lines might not deliver the presumed benefits of greater economic stability and resilience. Rather, these forces might ultimately foment even greater volatility, both economic and geopolitical. The burden of these shifts will fall disproportionately on low- and middle-income economies. Such developments are also leading to restrictions on the free flow of ideas and intellectual property. Restrictions of this sort come at the cost of hindering the advancement of technology and other forms of knowledge at a global level.

A retreat from globalization might leave countries feeling more secure and less exposed to global volatility. The costs of such a retreat will be less evident but will be large nonetheless, and all countries, both rich and poor, will one day come to rue their inward turn.

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