THE RETREAT FROM GLOBALIZATION

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The COVID-19 pandemic has hastened a process that began with the collapse of Lehman Brothers in 2008 and has gained further momentum during the era of Donald Trump. The second great wave of globalization is over, and everything from trade and technology to finance and economic governance has become vulnerable to radical change.

CAMBRIDGE – The world economy has experienced two great waves of globalization since the onset of the first Industrial Revolution in the late eighteenth century. The retreat from the second wave is now plainly underway. Will it be an orderly withdrawal to defensible positions or a rout, like Napoleon's retreat from Moscow?

Globalization's first great wave peaked in 1914 with the outbreak of World War I. It was propelled by transformative technologies: railroads and steamships, telegraphy and telephony, all of which vastly reduced the friction with which people, capital, and information moved across national borders (although protectionism on the part of the United States, Germany, and other countries constrained the movement of goods).

The second wave of globalization, beginning in the 1980s and accelerated by the opening of China and the collapse of the Soviet bloc, was driven by information and communication technology, which again facilitated the transnational movement of capital, goods, and even services like never before. Although the ICT revolution did not have a direct bearing on the movement of people, it inaugurated a new era of outsourcing and remote work.

Now, this second era of globalization appears to be in full-blown retreat on multiple fronts. Financial globalization was the first dimension to give way, starting with the collapse of Lehman Brothers in September 2008. The second, more recent breakdown is that of transnational integrated supply chains, which have been shattered by the COVID-19 pandemic. Mounting tensions between the US and China, and a new push by many countries to secure access to strategically sensitive products and materials, has intensified this process of disintegration.

Yet another dimension of the current deglobalization involves multinational corporations. Many have hubristically asserted their own political autonomy by using trade treaties to influence and even override national policy with respect to labor markets, environmental regulations, and intellectual-property regimes. They have also taken extreme advantage of the institutional mobility afforded by today's technologies to shift profits to the jurisdiction with the lowest tax burden.

These supranational tendencies have been facing resistance for a good decade now. Even before the 2008 financial crisis hit, Dani Rodrik of Harvard University had warned that the latest phase of "extreme globalization" creates a political trilemma. "Democracy, national sovereignty and global economic integration are mutually incompatible," he argued. "We can combine any two of the three, but never have all three simultaneously and in full." But even in China, Russia, or other non-democracies where there would appear to be no trilemma, governments that want to appear at least superficially responsive to citizens are pursuing greater national autonomy to limit the influence of globally integrated markets.

PICK YOUR POISON

Of the various dimensions of globalization, financial integration was the first to be called into querstion. The 2008 crisis laid bare the fragility of globalized financial markets in which institutional participants – banks and shadow banks – relied on sophisticated algorithms and raw computing power to generate seemingly infinite leverage. For a time, such "financial engineering" reliably increased profits and bonuses. But with leverage at such extreme levels, even a modest decline in asset values proved disastrous: a balance sheet leveraged at 30 to one could be rendered insolvent by an asset-price decline of less than 4%.

In the event, financial institutions' relentless pursuit of "efficiency" – squeezing the most profit out of their capital bases – created a dangerous lack of resilience, paving the way for unprecedented interventions by the world's central banks (led by the US Federal Reserve) when the bubble finally burst. Post-crisis regulations to restore and strengthen the financial sector's resilience have required banks to maintain higher capital reserves, which arithmetically translates into lower returns on capital and (perhaps problematically) lower compensation for those who generate the returns.

With COVID-19, another shoe has dropped. The pandemic has exposed a lack of resilience within the global economy's non-financial "real" sector: the world of production and distribution of goods and services. As Allianz's Mohamed A. El-Erian recently pointed out, "many firms will look to strike a more risk-averse balance between efficiency and resilience as they emerge from the damaging pandemic shock. The corporate world's multi-decade romance with cost-effective global supply chains and just-in-time inventory management will give way to a more localized approach involving the reshoring of certain activities."

Moreover, the aggressive drive to reduce costs at the expense of resilience has not been limited to transnational supply chains. As the physician and author Siddhartha Mukherjee recently noted, an analogous phenomenon with even more dire consequences has afflicted health care, where hospital administrators have increasingly embraced the same "market-driven, efficiency-obsessed culture" held by many corporations. As a result, he writes, "Questions about 'best practices' in management have become questions about best practices in public health. The numbers in the bean counter's ledger are now body counts in a morgue."

At least since Adam Smith's time, the discipline has identified the free market's signal virtue as its ability to allocate physical and financial resources efficiently. But when determining what one actually means by "efficiency," one must bear in mind two critical, mutually dependent questions: whether the evaluation is being conducted retrospectively or prospectively, and with respect to what time frame.

After all, pursuing prospective efficiency will necessarily tend to shorten the planning horizon, because the further one looks into the future, the greater the uncertainty. Corporate short-termism is not merely the result of managerial incentives that base executive compensation on the immediate stock price (though that certainly plays a role). It is also a problem affecting investment decisions more generally. Like investments in high-risk, high-reward research and development, investments in resilience to guard against shocks will be among the first things sacrificed in the interest of increasing profits for the immediately foreseeable future. As Rana Foroohar of the *Financial Times* observes, a reduction in short-term profits represents the cost of shifting from "just-in-time" to "just-in-case."

BREAKING THE CHAINS

As for supply-chain fragility specifically, the subject has been closely studiedby Vasco Carvalho of the University of Cambridge, who has recently extended his research program to account for the impact of the pandemic. As El-Erian also emphasizes, worries over supply-chain vulnerabilities have mutated into, and been reinforced by, concerns about national security, as exemplified by the anti-China rhetoric emanating from Washington, DC.

These are not illegitimate concerns. A key feature of the second wave of globalization was the widespread, deliberate offshoring of the US high-tech manufacturing base, principally (but not exclusively) to China. From semiconductors to solar cells by way of flat-panel displays, the hardware of the digital revolution is no longer made in America. Yes, the early Silicon Valley icon Intel still fabricates its microprocessors in the US, but it is the exception that proves the rule; even Intel lags behind the world's leading chipmaker, Taiwan Semiconductor Manufacturing Company (TSMC).

In this context, developing a coherent strategy for re-establishing competitive production capacity within US borders will not be easy. While TSMC recently announced plans to open a factory in Arizona, the fact that its output will be sub-scale and only produced to specifications that will be obsolete by 2024, according to the company's own roadmap, makes the move seem like little more than a political stunt.

Moreover, IT hardware is only one of many manufacturing domains that US companies have offshored under the imperative of efficiency. As the pandemic has shown, the same has also happened with critical medical supplies such as face masks and the reagents used in test kits, which are mostly made in China.

A provocative headline on a recent *ProPublica*story by Lydia DePillis helps to drive home the broader point: "To Understand the Medical Supply Shortage, It Helps to Know How the U.S. Lost the Lithium Ion Battery to China." DePillis recounts the sad tale of A123 Systems, a pioneer in advanced battery technology that received $249 million from the US federal government under the 2009 American Recovery and Reinvestment Act, plus an additional $135 million in grants and tax credits from the state of Michigan. Three years later, A123 declared bankruptcy, and a Chinese conglomerate acquired its assets.

A GREEN RENEWAL?

As New York Governor Andrew Cuomo has emphasized throughout the COVID-19 crisis, America has a chance to "build back better" after the pandemic has passed. To many observers, that slogan will be taken as an invitation to start investing in a low-carbon economy. There is a growing chorus calling for a response to climate change that matches the ambition and scale of the mobilization for World War II.

Yet the "how" of a mobilization to combat climate change will be as important as the "what." The A123 fiasco brings back memories of another notable failure of the 2009 stimulus package: Solyndra, a solar-panel manufacturer that received $535 million in US federal loan guarantees before filing for bankruptcy in 2011.

To be sure, these failures are partly offset by the success of another stimulus beneficiary: Tesla. But the damage was done. What followed was not more investment and renewed efforts to innovate, but a media firestorm and partisan recriminations over the government's involvement in the economy. As a result, China, rather than America, now dominates global production of solar panels, advanced batteries, and other critical new technologies.

If that were not bad enough, the US has missed out on a generation's worth of practice (that is, learning by doing) in creating effective public-private partnerships at the technological frontier. In fact, China's appropriation of this model for advancing technological innovation is more strategically significant than its success in stealing various elements of intellectual property.

It is worth remembering that all the components of the digital revolution were made in America, because most of the relevant R&D took place in US labs financed by the US government. But at least as important was that various US agencies, particularly within the Department of Defense, served as the industry's initial customers well before its products had become commercially viable.

In other words, Silicon Valley had what A123 and Solyndra did not: a customer motivated by a broader, long-term mission, rather than by short-term returns. Without a restoration of state intervention on the demand side to support innovation, the US will have no chance to lead the world in responding to climate change.

TRADING PLACES

It is no accident that the era of extreme economic and financial globalization that began at the end of the twentieth century coincided with a radical delegitimation of the state as an economic actor. US President Ronald Reagan's first inaugural address, in 1981, provided the slogan that would define the entire era: "Government is not the solution to our problem, government is the problem."

As Reagan (and Prime Minister Margaret Thatcher in the United Kingdom) reduced the role of the state, multinational corporations stepped into the resulting vacuum. From then on, they were increasingly empowered to advance their own interests through public policy, both foreign and domestic.

Tracing the implications of these developments in 2018, Rodrik writes, "as trade agreements have evolved and gone beyond import tariffs and quotas into regulatory rules and harmonization – intellectual property, health and safety rules, labor standards, investment measures, investor-state dispute settlement procedures, and others – they have become harder to fit into received economic theory." As a result, "Rather than neutralizing the protectionists, trade agreements may empower a different set of rent-seeking interests and politically well-connected firms – international banks, pharmaceutical companies, and multinational firms."

In the current context of renewed national assertiveness, it is reasonable to expect heightened sensitivity about and resistance to efforts to pursue such rent-seeking under the banner of free trade.

A final dimension of deglobalization involves cross-border tax arbitrage by multinationals, most notably the tech giants Amazon, Apple, Facebook, Google, and Microsoft. The fact that a corporation's accountants can arbitrarily move profits to low-tax jurisdictions from the locations where they are actually generated is one of the digital revolution's more perverse by-products. Not surprisingly, the political backlash against this practice is already in full swing, though not in the US, where it is most needed.

In recent years, both the International Monetary Fund and the OECD have mobilized broad coalitions of national actors to create a new international framework for taxing multinationals. And when it comes to Big Tech specifically, the French government has led the way with a proposed digital-services tax, under the acronym "GAFA" (in reference to Google, Apple, Facebook, and Amazon). These efforts may well result in a different kind of globalization, with intergovernmental agreements setting minimum taxes based on the quantum of revenues – not profits – recorded in different jurisdictions.

ONE LAST SHOT

In the retreat from the first great wave of economic globalization, two world wars bookended a period of hyperinflation and economic depression. As the second era of globalization winds down, we must hope for a less destructive denouement as governments grapple with the tensions inherent in Rodrik's trilemma. The push to tax multinationals and – lest it be forgotten – to reduce greenhouse-gas emissions under the Paris climate accord may yet engender a sufficiently stable equilibrium for a multi-polar world.

But, of course, much will depend on what happens in the US, which is currently mired in turmoil and dysfunction under woefully incompetent, utterly incoherent leadership. US President Donald Trump's impulsive nationalism is closely aligned with deglobalization more broadly, and his manner of dealing with friends and foes alike seems certain to make that process more contested and tumultuous. As I write in the second edition of my book *Doing Capitalism in the Innovation Economy*, revised for the Trump era, "It is already possible to imagine that, in retrospect, the most lasting legacy of this Administration will have been its contribution to accelerating China's advance to global leadership."

Evidence of this isn't hard to find. For example, unilateral moves to bar Huawei, the global leader in telecom equipment, from access to US technology are bound to speed up China's already massive investments in conquering the frontiers of design and production across the spectrum of strategic technologies, from energy storage to machine learning. Yet these US initiatives are unmatched by any comparable, positive programs of investment in building a twenty-first-century American economy. For such programs, as for much else, the US and the world depend on the outcome of the 2020 presidential election, as strategic a decision point as any in the three generations since the end of World War II.