Global economic integration: risks and challenges[1]

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"…like wind and water, globalization is powerful, but can be inconstant or even destructive."

The Great Convergence, Richard Baldwin (2016)

1. Introduction

In recent years, we have witnessed the **resurfacing of nationalism and protectionist policies**. These trends call for favouring national producers and restricting global flows of persons and goods. The arguments of those defending these policies are largely based on the notion that **globalisation has benefited the elites and penalised common workers.**

Due to globalisation, billions of people have entered the global labour market with very low wages. Enterprises in advanced economies have relocated their production to the new countries participating in international trade, attracted by lower wage costs. In parallel, the greater international mobility of persons has led to significant flows of immigrants from developing economies to advanced economies. Usually, immigrants are a source of cheap labour competing with the least qualified workers in host countries.

These flows, together with the possibility of production automation resulting from technological advances, have had a significant impact on workers in advanced economies (especially those with lower qualifications) both in terms of wage pressure and loss of jobs. The economic and financial crisis beginning in 2007-2008 exacerbated these problems, and as a result unemployment increased to record highs.

Therefore, **although over the last few decades the world has become much richer and inequalities between countries have eased, the risks of a reversal in the global integration**

[1] Prepared for presentation.

process are currently very high. The intensification of internal inequalities in advanced economies has given rise to growing social and political tension, which **compels us to look for a new equilibrium in the future.**

History shows that past efforts to deny technological progress or retreat from the processes of economic and financial integration have been mere parenthesis. The **notion that it is possible to halt these processes is an illusion because their vigour eventually overwhelms social and political resilience.**

2. Trends in the last few decades

Globalisation has intensified considerably since the early 1990s (this stage in the globalisation process is the 'second unbundling').[2] This shift was due to and sustained by two major structural changes:

- the technological revolution in terms of **information and communication systems**;
- political changes in Asia and the dismantling of the Soviet Bloc in Europe, which led to an **increase in the number of countries participating in international trade**.

The **concept of tradable has changed** in light of the technological capability to provide services remotely (e.g. call centres), improvements in transportation (e.g. air cargo) and the fact that information and communication technologies make it possible for firms to **break down and coordinate complex remote production activities**. A trend for offshoring the various stages of production emerged among firms in developed economies – to other countries, other firms or both – thus dispersing their production worldwide. This means that **the various components of a final product are now produced in different countries and assembled sequentially down the production chain in various locations, thus resulting in the so-called 'global value chains'**. This also led to a substantial change in international trade, with **a strong increase in trading of intermediate products** used to manufacture other products.[3]

These transformations in the international organisation of production and in international trade had major implications for countries and their citizens.

[2] As coined by Baldwin (2016).
[3] See, for instance, Amador (2017).

Developing economies, which typically have low labour costs and low-qualified workers, have benefited from the **creation of new jobs**, as well as from a rapid **influx of knowledge in terms of technology but also in terms organisational, management and marketing processes**. Global value chains have made the industrialisation process in these economies easier, faster and less risky, allowing them to enter into advanced technology sectors. As such, the **domestic product** of these countries posted **high growth rates**. Although the relocation of production was focused on specific countries (more specifically, in Asia and Eastern Europe), **the increase in global demand for commodities had a positive impact on many other developing economies**, particularly in Africa and Latin America, which also saw their income increase. According to the World Bank's poverty indicators, in 1981 approximately 1.9 billion people were extremely poor[4] (42% of the world population). By contrast, in 2013 only 767 million people were poor (given that the world population has grown significantly, the share of poor people has dropped to 11%). The main contribution to this improvement was made by China, where the share of the population below the poverty line decreased from 88% in 1981 to 2% in 2013.

In turn, in **developed economies**, **consumers have benefited from the increased possibilities afforded by the wider product choice** and an **across-the-board decrease in manufactured goods prices**. Furthermore, increased competition among firms and countries has fostered both **efficiency gains in resource utilisation and strong investment in innovation**. The empirical studies available suggest that activities upstream and downstream of the production process (e.g. R&D, distribution and marketing) broadly generate high added value. Typically, these activities remain in developed countries.

However, the relocation of production from developed economies to developing economies also had **substantial implications for their labour markets and for the distribution of domestic income**. Exposure to external competition, together with technological progress in terms of automation, have **put downward pressure on wages and on low-qualified and average-qualified workers:**

> *"American industrial workers are competing with robots at home and Mexicans abroad"*
>
> Baldwin (2016)

[4] People living on less than USD 1.90/day.

Indeed, the fragmentation in the production process has changed the nature of external competition, which has shifted from a 'sector-to-sector' to a 'component-to-component' approach, making competition among low-wage workers more direct. By contrast, more qualified workers have benefited from an expansion in their labour market, which has put upward pressure on their wages.

This means that **although globalisation has led to an increase in global income, gains have not been shared evenly among individuals and countries, with the emergence of clear relative and, possibly, absolute losers**.

In a recently published book, Standing (2014) discusses and expands on this issue, drawing attention to the **appearance of a new socioeconomic class**, which he calls the 'precariat' or 'globalisation's child'. The 'precariat' is a **group of people without jobs, or in jobs of limited duration and with minimal labour protection**. Their status **offers no sense of career and no sense of secure occupational identity**. The lack of prospects in terms of recognition, security and identity leads to frustration and **makes this class of individuals open to intolerance and prone to listen to populist ideas**, as already is the case in Europe and the United States.

In my opinion, this issue is related to another globalisation-linked problem, which has heretofore been neglected: **the lack of a proper governance model for the globalisation process**. Indeed, **there is a disconnect between the need for the international community to approach global problems stemming from increased globalisation and the effective power of actual policy decisions and instruments of action**, which are still chiefly domestic. Countries are required to solve domestic problems stemming from global trends, whose behaviour limits the effectiveness of their action (e.g. in terms of global value chains, the interests pursued by countries and firms are not always aligned). In a globalised world, **a number of issues must be treated as global public goods**. This includes environmental issues and financial stability, but also social cohesion within each country, given that the validity of international agreements critically hinges on support by the population. Indeed**, the international community does not have institutions with actual powers and commonly agreed instruments and procedures to effectively react to problems caused by globalisation, affecting a large number of countries**. It is crucial to **apply a win-win approach to globalisation gains, at both international and domestic level, to prevent the emergence of conflicts, blockages and self-destruction.**

3. Responding to challenges

Prescribing protectionist policies as a way to tackle the problems we face **is wrong**:

- **First,** because **impeding the efficient allocation of resources and promoting higher production costs** than those of the international market leads to a **loss of welfare for domestic consumers.**
- **Second**, because **enterprises develop their activity at global level, and may easily relocate to third countries,** if they have to bear higher costs for intermediate products. Protectionist measures might therefore be counter-productive.
- **Third**, because **technical innovation and the circulation of information make it increasingly harder to create a space for autarky**. Moreover, even if it were possible to transitorily create an autarky, by repressing the circulation of goods, services, capital and persons, **that situation would not be sustainable, as it would not allow the consumption aspirations of the populations to be met**.

In my opinion, we should ask ourselves **what is the best strategy to adopt in order to ensure high welfare levels for individuals, in a context of strong integration of the economies at global level and significant technological advances**.

While recognising that international trade generates positive-sum gains, it is fundamental to **define and implement re-balancing mechanisms ensuring win-win situations**. This implies:

- **The ability to redistribute income in favour of those with the greatest losses**. The benefits of globalisation must flow to all parts of society. For this, governments must seek to implement policies that protect the workers, rather than the jobs. This requires, on the one hand, strengthening the social and economic safety net, with a view to preventing the economic changes from making individuals' living standards precarious; and, on the other hand, developing training policies that support the adjustment of the workers to the new situation.

- **Implementing policies oriented to the medium-term that promote agile and innovative economies**. This involves the creation of conditions enabling the transfer of resources to more productive sectors. In this field, it is essential to take measures such as the simplification of insolvency procedures, the acceleration of judicial decisions, and the reduction of the context costs for enterprises. In addition, it is fundamental to promote entrepreneurship and invest in research and development.

Central banks and financial regulators and supervisors also play a fundamental role in promoting inclusive growth, particularly in safeguarding price and financial stability. This is the best contribution they could make to balanced growth, insofar as it may prevent arbitrary income redistribution and facilitate the planning of economic agents' decisions. In addition, by ensuring an appropriate regulatory framework, promoting a level playing field among financial service providers, and promoting financial literacy, central banks and regulators make an important contribution to individuals' financial inclusion.

- **Reformulating the global governance model**. Political leaders must be able to adjust their governments and societies to the new domestic and international governance requirements, in order to deal with the new conditions arising from globalisation. The recent economic and financial crisis has highlighted this need and, in this context, important steps were taken to strengthen the global governance model:

    - Coordination of macroeconomic policies, particularly in the earlier stage of the crisis;
    - Definition of global financial regulation (for instance, the establishment of the Financial Stability Committee);
    - Strengthening of regional and global financial assistance mechanisms to countries under stress (increase in IMF's resources, establishment of the European Stability Mechanism).

  However, these measures have still not gone far enough. In my opinion, the **strengthening of global governance should include a reinforcement of the mandates and instruments of existing multilateral institutions** (for instance, the IMF, the World Bank, the World Trade Organisation and the UN). Moreover, the need to respond to common concerns of different countries, but of a more regional or sectoral nature, justifies the creation of new multilateral institutions, in line with the recent example of the Asian Infrastructure Investment Bank. In parallel, it is important to strengthen the

more informal international cooperation fora with a more comprehensive and balanced geopolitical representation.

- **Ensuring a sustained development process at domestic level.** Successful integration implies that each country pursues an economic policy promoting sustainable growth, capable of delivering higher welfare levels to the population, in parallel with a reduction in social inequalities. This means ensuring the continued sustainability of public and external accounts, as well as levels of competitiveness consistent with job creation.

4. Reform of the European governance model

The European Economic and Monetary Union (EMU) is an excellent example of integration and cooperation among countries in a globalised world. It is built on the sharing of sovereignty among Member States, with a two-tier governance system – central and national – which aims to combine the interests of the whole with the specifics of its parts.

The European governance model has always been guided by a concern for the management of Member States' social and territorial imbalances. Each phase in the integration process corresponds to new models and mechanisms to safeguard the cohesion of the whole (such as the European Regional Development Fund, the European Social Fund and the Cohesion Fund). Within the globalisation process, the European Union (EU) follows a policy where trade agreements established with other economies are accompanied by governance rules and models which take into account non-commercial aspects of global interest (for example, environmental or food safety concerns).

The great challenge for the EU is knowing whether it has the instruments and institutions to address the dynamics of integration and the challenges of globalisation.

The economic and financial crisis made it clear that the **EMU's institutional framework and governance model were clearly inadequate for the stage of integration** of Europe at the time. As a consequence, the European response to the problems that arose was often reactive and tardy.

Consequently, over the past seven years, **significant changes had to be introduced in the EMU's economic and financial governance architecture**, many of which would have been unimaginable ten years ago.

Economic governance was reinforced by strengthening the Stability and Growth Pact and introducing a macroeconomic surveillance framework to identify fundamental macroeconomic imbalances and the measures to resolve them. The **European Stability Mechanism** was created, a European instrument for financial assistance to Member States in crisis situations (i.e. a backstop).

In addition, a crucial step was taken towards safeguarding financial stability with the creation of the **Banking Union**, which saw notable progress in a short period of time, particularly with the establishment of the Single Supervisory Mechanism and the Single Resolution Mechanism. However, the Banking Union project remains incomplete, given the lack of a third pillar – a common deposit guarantee scheme.

Work is under way to achieve the **Capital Markets Union**, which is crucial for counteracting a scarcity of investment in Europe, creating new opportunities for savers and investors and bringing the financial sector closer to the real economy.

These reforms are very important steps to building a Union which is sounder and better equipped to withstand adverse shocks in a globalised world. Nevertheless, **in my opinion, in order to recover the credibility of the European project and ensure a sustainable and prosperous EMU, we need to go further with institutional and governance model reforms.**

As I have said publicly on several occasions, I believe we need to **create, in the euro area, a central decision-making body that is strong, independent and democratically accountable,** which anticipates and responds to problems, taking into consideration the euro area as a whole. A possible alternative would be to reform the Eurogroup.

I also believe that the **European Commission**, given that it has become increasingly active in the executive arm, in addition to its monopoly of the legislative initiative, needs to be streamlined and to evolve towards an organisational model similar to that of the European Central Bank, where:

- the legislative initiative would be given to a College of Commissioners, with one representative per Member State;

- and the executive functions would be given to a smaller executive body, scrutinised by the College of Commissioners.

The **European Parliament** itself needs to be rethought in order to include within its scope the establishment of a **chamber representing the euro area**, which would scrutinise and, consequently, hold accountable and legitimise economic and political developments in the euro area.

In addition, an institutional leap is needed in order to transform the European Stability Mechanism into a **European Monetary Fund**. The European Monetary Fund would be an institution independent from the Member States, mandated and equipped to negotiate financial assistance subject to conditionality. The establishment of such an institution would create the conditions necessary for the development of solutions that are to everyone's advantage and essential to the cohesion of the whole EU.

To sum up, regaining public confidence in the European project as a platform for achieving their welfare goals depends on the ability of European institutions and policy-makers to put in place **a model that balances the benefits of integration with democratic representation and social cohesion**. This means **that it is essential to implement an ambitious governance model supported by institutions that are sound, legitimised and accountable, and capable of ensuring the effective application of rules, in a fair and consistent manner.**

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