Globalization has fueled greater economic growth but has also been a highly disruptive force that has fed the rise of populism, deepened income inequality, bolstered anti-immigrant sentiment, and increased global financial risk. What is the future of globalization, and what policies can address its challenges? The Julis-Rabinowitz Center for Public Policy and Finance’s seventh annual conference, The Future of Globalization: Trade, Finance and Politics, brought together academic experts, policymakers, and journalists, to weigh in on this very important and timely question. The discussion is summarized here.

Do we have the right metric?

Hyun Song Shin started the discussion by arguing that as firms operate globally, the nature of economic activity — with ownership, management, and production all dispersed geographically — is increasingly at odds with a system for measuring such activity that relies on national boundaries. This divergence has important implications for policy, as traditional measures such as GDP or the trade balance may under- or overestimate the true magnitude of economic activity and result in flawed policy prescriptions.

Working through several examples, Shin showed how “offshoring” distorts national accounts, how changing the location of a firm’s headquarters (redomiciliation) challenges the measurement of investment income, and how the movement of intellectual property across borders impacts GDP and balance-of-payments statistics.1

To understand how these measurement issues arise it is important to be clear about the key concepts of “residency” and “domicile.” Under the existing balance of payments framework, residency is a legal relationship between an economic entity and “the economic territory with which it (a person, firm, or other legal entity) has the strongest connection, expressed as its center of predominant economic interest.” 2 Therefore, exports from a given country do not need to ever cross the country’s physical boundaries. For example, a firm which is resident in country A can enter into a contract-manufacturing agreement (offshoring) with a firm in country B, and sell the output in country C. The good is shipped from B to C, and never touches country A. The sale would nevertheless be counted as an export of country A, and would enter its trade and GDP statistics. Country A’s GDP would go up even if no workers are employed domestically.

The concept of “domicile” is more complex than residency denoting both greater permanency and origin of the entity. Frequently the domicile of a firm maps onto the location of its headquarters. Changes in domicile carry well-known implications for taxation but also, said Shin, generate a cascade of lesser-known changes in bilateral relations between countries along the global value chain. Even if there are no fundamental changes in the location or scope of economic activity, redomiciliation has significant consequences for the balance of payments of the countries involved.

As firms operate globally, the geographically dispersed nature of economic activity is increasingly at odds with a system for measuring such activity that relies on national boundaries.
The Future of Globalization: Trade, Finance & Politics

Seventh Annual JRCPPF Conference Summary

The Julis-Rabinowitz Center for Public Policy & Finance

Due to different accounting treatment of direct investment income (recognized when it is earned) and portfolio investment income (recognized when it is actually paid out).

Shin also noted that the focus on the trade of goods and services as an indicator of external imbalances is misleading, because it ignores the dynamics of international trade in assets. Profits, interest, and dividends from the ownership of foreign assets (primary income receipts) are increasing in importance relative to trade flows, particularly in financial centers.

Another important consideration involves the profits that global firms hold in bank accounts and other financial assets. As these profits grow, these firms are in effect acting as lenders rather than borrowers.

It is time to rethink how we account for the economic activity of global firms. Until these issues are addressed, policy makers should exercise caution when using traditional ratios such as debt-to-GDP or credit-to-GDP to assess the state of the economy.

Déjà vu?

Recent years have been marked by a mix of populism, anti-immigrant sentiment, protectionism, low interest rates, and low growth. Are these new phenomena or have we seen them all before? In the conference dinner talk, Douglas Irwin, argued that history is repeating itself, albeit with some variations. Presenting his new book, Clashing over Commerce: A History of U.S. Trade Policy, Irwin described how and why trade has been a source of bitter political conflict since the country’s founding. The political dissension we see today is nothing new. Historically there have always been factions concerned about foreign “unfair” trade practices, past presidents who knew little about trade, partisan positions rooted in economic geography reflective of different regional endowments and interests, and economic populists who tried to upset the status quo.

Irwin noted that despite conflict and volatility over the course of U.S. history, the structure of the nation’s tariffs has been remarkably stable. Why? Continuity in the tariff structure is the result of persistence in the location of production, the composition of exports and imports, and regional economic interest, and as a result, persistence in congressional votes on trade. Traditionally, the North has supported high tariffs while the South and the West supported low tariffs.

Over the past 230 years, tariff policy has served different primary purposes that roughly correspond to three different time periods: revenue generation (1790-1860); restricting access to domestic markets by foreign competitors (1860-1934); and reciprocity to improve access to foreign markets for domestic firms (1934-present). Transitions from one regime to the next were triggered by shocks and the resultant political changes — the Civil War (power shifts to the Republicans in the North) and the Great Depression (power shifts to the Democrats in the South).

It’s unclear if the U.S. is currently in another major transition. Because shifting the status quo requires a major shock, Irwin concluded that the Trump administration’s attempts to selectively raise tariffs or dodge trade treaties is unlikely to transform the overall trade regime.
Populism

In his keynote talk, *Globalization and the Populist Backlash*, Dani Rodrik affirmed that populism and globalization are intertwined. Globalization, as it progresses, has historically been accompanied by an upsurge in populism and anti-globalism, said Rodrik. Why so? The advanced stage of globalization generates both large income redistribution effects and widespread economic anxiety. On their own, these are insufficient to give rise to populism. Political leaders are also required to shape public sentiment and provide an overall narrative as well as a target for the discontent. The particular cleavages around which the narrative is built determine whether populism manifests itself as right- or left-wing. In the U.S., left-wing populism first emerged in 1896 when William Jennings Bryan railed against tight money and free capital flows, targeting Northeastern financiers and banking institutions — the champions of the existing system of economic globalization.

Economists have always emphasized the gains from trade but also recognized the distributional impacts, Rodrik explained. In standard models with more than one factor, reducing tariffs or other barriers to trade will result in one of the factors of production losing not only in relative terms but also in absolute terms. These redistributive effects loom larger as the barriers removed become smaller. Trade agreements thus become more contentious in the advanced stage of globalization. Recent research suggests when tariffs are already low, any further reductions have large redistributive effects; some estimates imply that the economy reshuffles $10 of income per $1 gain from trade generated.4

An important feature of the current state of globalization is the asymmetry between the cross-border mobility of capital and the restrictions on movement of labor. Because capital is mobile and labor generally is not, the demand for labor becomes more elastic and capital’s share of income tends to rise and labor’s share tends to sink. And, the factor that is fixed (labor) rather than the one that is mobile (capital) bears the incidence of shocks and the costs of taxation. Data shows that opening up the capital account lowered labor’s share of income and increased inequality, it has also spurred the international race to the bottom in corporate tax rates.

Is it possible to correct for the redistributive effects of open trade? Rodrik concluded that given the current levels of trade barriers, taxing winners to compensate losers would eat up most of the gains from trade. He noted that in Europe the strong welfare state has mitigated the distributive effects and allowed for greater openness and less opposition to trade. In contrast, trade liberalization in the U.S. in the 1990s and 2000s coincided with a weakening of social safety net and the compensation to labor was meager, ineffectual, and inconsistent, boosting popular opposition to trade. Furthermore, in the current advanced stage of globalization, the differential mobility of capital and labor makes it impossible to tax capital to fund social insurance, so the welfare-state bargain that worked in Europe is unsustainable.

Globalization is more contentious than domestic competition or disruptive technology, because it is perceived as unfair. Indeed, globalization forces competition under rules that are often different from one country to another. In domestic markets agents perceive that they are operating under the same ground rules, but in globalized markets, agents perceive that competition is unfair as
competitors may be allowed to exploit labor, harm the environment, or receive government subsidies. The perceived unfairness magnifies popular opposition.

Rodrik ended his talk by urging economists to distinguish between good versus bad populism. He noted that many populist ideas considered “crazy” when first proposed, such as banking regulation and abandoning the gold standard, are now mainstream. The earlier U.S. populism culminated in the New Deal, Rodrik noted. So, when are populist reactions against the economic mainstream justified? Given that economic policy is often subject to a dynamic inconsistency that distorts outcome, economists generally prefer restraints on policies. As preferences and behaviors shift in response to announced policies, the optimal plan today will not be optimal tomorrow. Because of this dynamic inconsistency, politicians left on their own may harm the economy and lead the economy to high inflation or to protectionist traps. But what if particular groups, such as lobbyists, pharmaceutical companies, multinational companies, investors, or financial institutions, capture the political process and design policies and institute restraints not to protect themselves from their future selves but to protect themselves against future majorities? In this case, the restraints serve self-interest rather than safeguarding the interest of the majority. The kind of economic populism that culminated in the New Deal forestalled the much more damaging type of populism, one with no regard for norms of pluralism and liberal democracy. So, perhaps it is time to consider economic reforms that go against some of the “sacred cows” — whether these are international trade agreements or delegating responsibility to technocratic regulatory agencies.

### Immigration and inequality

How does immigration impact the labor market? **Ariel Burstein** presented new work addressing this hotly contested issue. Unlike previous studies that focused on comparisons across regions or among groups with different levels of education, Burstein and co-authors examined intra-regional variation in employment and wages across occupations that were differentially exposed to immigration in two dimensions: immigrant-intensity (how important immigrants are in that occupation) and tradability (how tradable is the output produced by the industry or occupation).

Burstein found that in the U.S. immigrants crowd out native workers in immigrant-intensive occupations and in industries that are less tradable. In more tradable occupations this effect is not found. Why is this so? The answer lies in the sensitivity of demand to price changes — tradable occupations face more elastic demands compared to less tradable ones. Tradable occupations adjust relatively more through changes in local output (more textiles are produced and exported, for example), and nontradable occupations adjust relatively more through changes in local prices (housecleaning services become cheaper). So, tradable occupations tend to have more crowding-in and less crowding-out than nontradable occupations, and wages fall more in nontradable compared to tradable occupations. By simulating a reduction in immigrants from Latin America, who tend to have low-education levels, Burstein and his co-authors found that wages rise for native-born workers in immigrant-intensive nontradable occupations (housekeeping) relative to less immigrant-intensive nontradable occupations (firefighting) by much more than for similarly immigrant-intensive tradable jobs (textile-machine workers).
Andrés Rodríguez-Clare, presented a novel framework that simultaneously quantifies both the aggregate and the distributional effects of trade. Traditional analysis based on gravity models provides estimates of overall gains but can say little about distributional implications. Recent empirical models find relative distributional effects of trade but say nothing about overall welfare effects. Rodríguez-Clare and co-authors developed and estimated a multisector gravity model with heterogeneous labor that is able to quantify not only the relative but also the absolute effects of trade on groups defined by geography (commuting zone) and by education (high and low). Applying their model to analyze the impact of imports from China on the U.S., they found that while there are net aggregate gains (0.3% of GDP over the 2010-2011 period), there are also concentrated losses. A small number of groups, representing about 7 percent of the population, experience losses as high as five times the average gain. The geographical distribution of gains and losses is similar for high- and low-education workers, but losses tended to concentrate in certain geographical regions such as Appalachia and parts of Southern California. The authors also found that trade increased inequality, but their model, however, was unable to capture the effects of trade on unemployment. This is an area for future research.

Manufacturing

The next topic addressed was external economies of scale (EES) and industrial policy from the perspective of trade. EES are economies of scale in production, in a location, in a country, or in an industry that an individual firm cannot affect and are separate and distinct from internal economies of scale that depend on how a firm chooses to produce. EES are central to the widely used gravity model of trade and are a common rationale for industrial policy. Estimating the size of these EES is hard, since doing so requires finding right the metric of success for an entire industry and identifying an exogenous change in the scale of the local industry in order to measure how success changes when scale changes.

David Donaldson presented a new approach to estimating external economies of scale (EES) and industrial policy. He found positive EES in different manufacturing sectors finding positive EES ranging from 0.02 to .20 elasticity. This means that if a sector with a 0.2 EES were to double in size, its productivity would increase by 20 percent. At the high end of the range, doubling the size of an industry in a given location would result in a 20 percent aggregate increase in productivity — a fairly large effect. Nevertheless, should a country implement an optimal industrial policy to leverage EES, the aggregate impact on the country’s GDP would be modest, not more than 0.2 percent of GDP.
GDP. This is in contrast to the gains from optimal trade policy estimated at 0.8 percent of GDP. Countries are sometimes accused of deliberately depreciating their currencies to gain trade advantages, but is real exchange-rate (RER) depreciation at all effective in fostering innovation and productivity? This was the question addressed by Laura Alfaro. Using detailed firm-level data for a large set of countries for the period 2001-2010, Alfaro and her co-authors found significant positive effects only in emerging Asian economies, where real exchange-rate depreciations were associated with faster growth of firm-level total factor productivity, sales and cash flow, higher probabilities to engage in research and development, and exports. There were no significant effects in industrialized economies, and in other emerging economies the effects were negative. The researchers built a dynamic model to capture these stylized facts. They found that the impact of RER on firm-level outcomes varies across economies according to export orientation, dependence on imports of intermediates, and on financial development. RER changes, even temporary ones, have persistent effects on total factor productivity and innovation. These changes are asymmetric and nonlinear.

The downward trend in global real interest rates since 1980 is not due to technological change or demographics, but rather a reflection of “global financial cycles.”

Laura Alfaro, Warren Alpert Professor of Business Administration, Harvard Business School
Hélène Rey, Lord Bagri Professor of Economics, London Business School

International finance

Shifting the focus to capital flows, Hélène Rey, discussed the downward trend in global real interest rates since 1980. Is the persistence of low real rates a consequence of technological change or demographics, as some have argued, or is it a reflection of global financial cycles—large co-movements of variables such as capital flows, credit creation, asset prices, and leverage? Using historical data going back to 1870, Rey and co-authors found several prolonged periods of low real interest rates in the U.S. Their analysis of aggregate consumption, wealth, and asset returns over those periods showed that the global ratio of consumption/wealth (C/W) anticipated movements in the global real interest rate. Irrational exuberance in asset prices (as in the Roaring Twenties and the “exuberant” 1990-2000s) leads to a fall in the C/W ratio, as wealth rises very quickly, typically followed by a severe global financial crisis, an extended period of increased savings and low consumption, and low real interest rates. This suggests that global boom-bust cycles are a strong determinant of short-term interest rates and that based on the empirical estimates the current world real interest rate is expected to remain low or negative for a long period of time.
Next, Rey addressed the effectiveness of monetary policy in a global economy with free capital flows. She noted that for decades international economics has postulated that countries face a “trilemma”: fixed currencies, independent monetary policy, and free capital mobility cannot go together. However in recent years even countries with floating currencies have been unable to control interest rates and have suffered the ravages of capital flow surges and reversals followed by financial crisis. So, countries now face a “dilemma”: independent monetary policy or free capital flows. Rey and her co-author estimated the impact of a U.S. monetary policy shock that raises the federal funds rate. Their analysis supports the idea of a global financial cycle in capital flows, asset prices, and credit growth. Rey’s findings suggest that this cycle is not aligned with countries’ specific macroeconomic conditions, but rather that it is aligned with the U.S. monetary policy, which affects leverage in global banks, capital flows, and credit growth in the international financial system. U.S. monetary policy influences monetary and financial conditions not only domestically but also globally and the other nations’ monetary policies are impaired regardless of the exchange-rate regime.

Returning to the topic of interest rates, Wenxin Du, discussed covered interest rate parity (CIP). For many decades, CIP—which states that the interest rates implicit in foreign exchange swap markets coincide with the corresponding interest rates in cash; otherwise, risk-free arbitrage opportunities will emerge—was the unassailable principle of international finance. The great financial crisis brought CIP’s vulnerabilities to the surface. From the 1960’s until 2008, CIP deviations were traditionally very small and short-lived, but this is no longer true. Since the crisis there have been large, variable, and persistent violations of CIP. What explains these CIP deviations? Is it the usual suspects such as transaction costs, counterparty risks, and limits to arbitrage—or are there other culprits?

Du and co-authors noted that in practice arbitrage typically requires borrowing and lending through banks, and banks face balance-sheet constraints that limit the size of their exposures. So, persistent deviations from CIP must arise because banks do not or cannot exploit such arbitrage opportunities. The researchers found a triangular relationship between the strength of the U.S. dollar, cross-border bank lending in dollars, and deviations from CIP. A stronger dollar is associated with wider CIP deviations and lower growth of cross-border bank lending denominated in dollars. The key conclusion was that the dollar spot rate is a risk barometer for global capital markets because it affects bank leverage and risk taking. When the dollar strengthens, CIP deviations widen and dollar-denominated cross-border flows contract.

Digging deeper into CIP deviations, Javier Bianchi talked about several economies that experienced large capital inflows and accumulation of foreign reserves when their interest rates were close to zero. Bianchi and his co-authors found that these facts can be explained by the central bank’s pursuit of an exchange-rate policy aimed at preventing appreciation when the domestic interest rate is at the zero lower bound (ZLB). In an economy that is far from the ZLB, the central bank can engineer an exchange-rate depreciation by lowering the domestic nominal interest rate. But what if the rate is close to zero? Using a simple monetary model with limited international arbitrage and central bank intervention in foreign exchange markets, the researchers found that at the ZLB the central...
The future of Europe

In the last session of the conference, Jaume Ventura began by considering globalization’s impact on the nation-state. Taking a historical perspective, Ventura pointed out that there have been two waves of globalization in recent centuries. The first from 1830-1914 saw a decline in the number of countries from 125 to 54. The second from 1950 to the present has seen an increase to a record high of 190 countries. But the global political fragmentation in the latter period has been accompanied by the emergence of structures of supranational governance. According to Ventura, states pursue trade opportunities by adapting their political structures. In the first wave of globalization, borders were removed by expanding empires — war was the way to conquer markets. In the later period of globalization, borders were removed through international economic and trade unions, which allowed for reductions in country size, and negotiation replaced war as a tool to ensure market access.

What are the implications for the future of the European Union? After its inception in 1957, the EU grew in size and scope to include 28 member states by 2013. In June 2016, however, the UK decided to leave. Although other countries may follow the UK example, Ventura argued that Europe is undergoing a transition from 19th-century nation-states to a 21st-century state characterized by a maze of overlapping regional jurisdictions. How this transition is handled is the most important challenge for Europe today.

Soumaya Keynes listed many pressing economic issues weighing down the EU, discussed proposed fixes, and considered the likelihood of their implementation. She noted a wide range of issues from financial stability, to debt, to fiscal rules, to the lack of a system-wide backstop and lack of
mechanisms to adjust to asymmetric shocks. She also considered the numerous proposals — many stemming from technocratic circles — to fix the problems, including the issuance of so-called European Safe Bonds, the creation of a common deposit insurance scheme, replacing the European Stability Mechanism with a European Monetary Fund, creating a central fiscal stabilization fund, easier credit for countries that engage in structural reforms. Which of these proposals will actually be implemented? And will they be enough to restore the reputation of the EU and prevent the next crisis? She concluded that it all depends on the politics, adding that some proposals face stiff opposition.

Keynes noted that the problem is that each country has its own narrative about the causes of its problems and whom to blame. While the technocrats are looking for solutions, nations are talking about their own problems, and no Europe-wide debate is going on. As a result, there is no hope for convergence. Furthermore, the fixes are boring and are hard to sell, undermining momentum toward reform. At the same time, political engagement is low, and elections are based on national issues. To break this impasse it is important to find a way to effectively communicate the technical issues to the public.

In Conclusion

Overall this conference brought together historical evidence, political-economy analysis, and cutting-edge economic research to uncover the forces driving anti-globalization sentiment, to correct misconceptions regarding the impact of trade and immigration, to clarify the limits of economic policy in an integrated world dominated by the U.S. dollar, and to challenge the economics profession to question its fundamental tenets if we are to effectively meet the challenges of globalization.

The current populist backlash to trade and globalization should not surprise us. As globalization advances, redistributive effects dwarf the gains from trade, making it impossible to effectively compensate the losers. Opening the capital account not only shifts the gains toward capital and away from labor but it also limits the power of domestic monetary, exchange rate, and fiscal policies. But, there is no turning back. The overall welfare gains are real, the trade structure is persistent, and global firms with their worldwide value chains are here to stay.

The conference raised important issues for future research, including the mismatch between how economic activity is conducted (at a global scale) and how we measure it (within national boundaries), improved estimates of the impact of trade on unemployment, and better communication of policy to obtain popular support for measures to be enacted.

Globalization has fueled populism, which can be a threat to democracy or an opportunity for reform. Economists need to strive to identify the “good” populism in order to forestall the “bad,” Rodrik said, and doing so may require sacrificing some of the “sacred cows of economics.”
Endnotes

1 Stefan Avdjiev, Mary Everett, Philip R Lane and Hyun Song Shin "Tracking the International Footprints of Global Firms" (2018) BIS Quarterly Review https://www.bis.org/publ/qtrpdf/r_qt18033.htm.


6 The gravity model is a widely used empirical model that predicts bilateral trade flows. In its simplest form, the explanatory variables are a variable representing economic size and a variable measuring distance between two economic units.


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