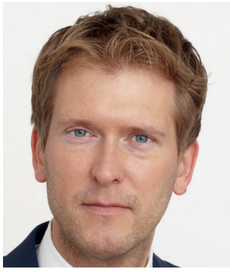

Did the crisis cause a change in globalization?

Implications for international business

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Globalization and the crisis

The financial and economic crisis of 08/09, beside its damaging impact on economic activity, also interrupted a long period of prolonged globalization.[1] After the end of World War II, the political effort of the industrialized countries to encourage economic integration and political cooperation restored economic prosperity and maintained peace.

Subsequently, the end of the Cold War supported an increasing dynamic in international trade, and a reduction of trade tariffs and capital controls. Regional integration as a first step to international free trade, such as the single European market, NAFTA, AFTA and the Mercosur, was intensified and enhanced every party's economic prospects and promoted economic growth. This led to the conviction that mutual gains can be accomplished with further attempts of economic integration.

A drawback of this globalization process is that it makes economies and markets more interdependent than they have ever been before. This is as good in flourishing times as it is bad in times of crisis. Globally highly interdependent markets, such as financial markets, lead to strong spillover effects and contagion in times of financial crises in one country, as seen in 08/09. Globalization and the interconnectedness of economies have made an international dimension of economic crises more likely.

Mutual gains from economic integration and intensified economic and political cooperation, where every party profits, are now perceived to be replaced by gains which are just made on the expenses of other parties (ie. situations which are zero-sum in game theoretical terms). This amplifies distributional conflicts and make isolating tendencies of countries, for instance through trade protectionism, more likely.

The magnitude of the crisis also demonstrated how little we know about the links through which economies are interconnected. Additionally, the path out of the crisis is unknown yet. Theoretical causalities and empirical correlations seem to give nearly no orientation. The resulting uncertainty is almost paradigmatic. The measures taken to overcome and prevent future crisis, such as the enormous liquidity provision by major central banks, the implementation of macro-prudential policies as well as the political efforts to reform the institutional deficits of regional and international integration, are themselves sources of today's' economic and policy uncertainty. This uncertainty, beside its effect on international business and investment decisions, also partly led policy makers to focus more strongly on domestic needs than on what is best from an international perspective.

Thus, what we have recently observed is slight de-globalization tendencies, or at least a stop in globalization. For instance, according to a report of the European Commission from September 2013, 154 new measures of trade protectionism were adopted worldwide and only 18 measures were abolished between May 2012 and May 2013.[2] Especially, emerging economies such as Argentina, Brazil, India, Indonesia, Russia and China among others keep applying a high number of trade-restrictive measures. Since trade is an important contributor to economic growth and emerging economies are highly dependent on pre-products imported from other countries, they should have a real interest to keep their economies open to international trade. The reality, however, is different.

Similar measures are applied on the financial side. Since interest rates in industrialized economies hit the zero lower bound to stimulate domestic demand, search for yield of international investors led to enormous capital flows into emerging markets, where interest rates are relatively high. As soon as interest rates are raised in industrial economies, these flows will revert and are likely to hurt emerging economies which are less stable to sudden outflows. For this reason many of these countries implement capital restrictions to at least partly control these massive capital flows. This kind of 'isolating behaviour' is not solely limited to emerging economies. US campaigns like 'Buy-American' or the EU's trade reforms of the recent years show similar tendencies.

Since the World Trade Organization (WTO) has a watchful eye on trade-restrictive measures, many new forms of protectionism are not even directly related to trade tariffs or quotas, and the degree of protectionism is therefore usually underestimated. For instance, many firms are government-owned, subsidized or somehow government-protected and can therefore more easily compete for business with other international companies. These hidden protectionism and industrial policy in order to boost the domestic economy on the costs of other countries (beggar-thy-neighbour) are a recent trend among protective countries in order to avoid WTO rules and intervention on trade tariffs.

Even more subtle are countries' strategic efforts in getting independent of external supply of scarce resources, especially energy resources. One example here is the US interest in new extraction methods like fracking, which has led to a shale-oil boom in the USA. Another example is the ongoing conflict between Russia and Ukraine about Crimea. In contrast to the officially declared interest by Putin's government to protect ethic Russians on Crimea from the Ukraine government, there might be a simpler motive. It is believed that the Black Sea around Crimea contains substantial sources of oil and gas. Thus, with a declaration of Crimea to Russian territory, all founds of oil and gas in the region would benefit Russia.

All these examples demonstrate countries' recent tendencies to apply protective measures or potential distributional conflicts about scarce resources. How strongly these tendencies are connected to the damaging effect of the crisis is open for debate.

The missing institutional framework

To summarize here, globalization and the interconnectedness of economies made global economic crises more likely due to stronger spillover and contagion effects while the recent crisis itself might have led to at least a stop in globalization.

What lessons, if any, can we learn from this development? It has to be stressed that this article is far away from arguing against globalization. Rather it argues that the speed of globalization in economic terms, communication and transportation of the last decades was not strongly-enough accompanied by the same speed of a build-up of a regulating international institutional framework, especially for the case that something goes (terribly) wrong. The economic idea of free trade and free markets does not postulate that there should be no international standards and rules at all.

Two recent examples might demonstrate this lack of an international legal framework. During the European debt crisis, Greece was, without any help from European guarantees, virtually bankrupt. Currently, Argentina faces the same problem and is de facto insolvent since the end of July. Now it fights with two US hedge funds about a settlement. At the same time Argentina accuses the US Government of violating its sovereignty. One of the problems for these cases is that there is simply no binding international law which regulates sovereign default.

The Greek case reveals that even on the regional level of the European Union appropriate institutional measures are missing to regulate sovereign default. Beside an international legal framework, it also needs independent international institutions which are authorized to enforce these rules and to take care of a country's insolvency process.

Already at an earlier stage, to prevent a sovereign default to happen, strict deficit rules for the countries' public debt must be implemented. In the European Union, the convergence criteria (Maastricht criteria) were implemented in order to discipline countries' public debt. However, the incentive structure was misaligned. Since potential future deficit countries decided on present deficit countries, the criteria were not as binding as they supposed to be. An independent institution would be a more credible alternative to discipline every party to the agreed criteria. This is necessary to enhance European fiscal and financial stability.

An institutional framework is even more amiss on a global level. Obviously, rules and regulation which suit everyone is even more complex and difficult to achieve when so many different countries are involved. However, progressive globalization, especially in the economic dimension, calls for a legally binding framework which disciplines all parties to stick to it. Although the crisis had to unravel deficits like the ones mentioned above, at least it initiated a vibrant discussion about possible solutions now. The crisis should be seen as a wake-up call in this sense. It should be clear that, instead of isolating policies and foreclosing markets and economies, the appropriate answer to these deficits are intensified international cooperation and the build-up of binding rules.

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Implications for international business strategies

The dynamic of globalization has changed. This has important implications for companies with an international business strategy, at least in the short and medium term.

First, companies' international business strategy should take into account countries' strategic tendencies to protectionism policies and their increased focus on national interests. In comparison to earlier decades, where the USA and Europe dominated the international political agenda, the growing influence of China and other emerging markets makes free trade negotiations more heterogonous. Multilateral trade agreements between many countries, eg. reduction of trade tariffs, will be harder to achieve in the future. More likely are intensified bilateral or regional agreements among groups of countries which are more homogenous and share similar economic interests. One example for this trend from global multilateralism to regional multilateralism is the ongoing negotiations between the European Union and the USA concerning the Transatlantic Trade and Investment Partnership (TTIP).[3]

Second, geopolitical and distributional conflicts such as that between Russia and Ukraine affect foreign direct investment and affect companies with a strong regional linkage with these countries. Furthermore, the reorientation to capital controls and restrictions, especially from emerging economies, affects companies' investment strategies.

Additionally, due to the high (policy) uncertainty together with the enormous liquidity provision by central banks, volatility on international financial markets increases. Since orientation about a future path of the real economy is missing, financial market participants also react more strongly to new information, the expectation formation process is disturbed. This raises the risks for companies' portfolio investments as well.

At last, correcting the unravelled institutional deficits on a global level is not just important for its own sake and for a fruitful future cooperation of countries, but also to reduce uncertainty induced by policy. For the moment, it is mostly this uncertainty which makes companies to postpone investment decisions and is therefore partly responsible for the slow and inert recovery we face in many industrialized countries. As long as these uncertainties are not resolved, we can expect the slow dynamic of recovery to remain.

Finally, industrialized countries have to face the fact that in the medium and long term the international distributional power will shift to the advantage of former emerging economies. They have grown up and want to be part of the determination of the rules of an international economic order as well. They are willing and able to enforce their economic interests. The change of the dynamic in globalization with all its complex ingredients, intensified by the damaging effect of the crisis, may partly reflect this process and is important for considerations of international business strategies. ■

1. This is also confirmed by the changing trend of the KOF Index of globalization since 2007 (Compare KOF Press Release 16 (March 2012): KOF Index of Globalization 2012 - Economic Crisis Brings Economic Globalization to Fall).
2. Compare European Commission (2013): Tenth report on potentially trade-restrictive measures, available at http://trade.ec.europa.eu/doclib/docs/2013/september/tradoc_151703.pdf, accessed on 20/08/2014.
3. Compare Straubhaar, T. (2014): The Transatlantic Trade and Investment Partnership (TTIP): From Global to Regional Multilateralism, in: Transatlantic Academy (Hrsg.), Liberal Order in a Post-Western World, Washington, DC