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Globalization Today

Updated rules for international trade, coupled with stronger domestic policies, could make globalization more inclusive and sustainable

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FOR AT LEAST 150 YEARS, global economic forces have by turns pulled countries closer together and pushed them farther apart. Ever since the industrial revolution and emergence of the first truly global economy in the 19th century, countries have at times sought more economic integration and at other times more isolation, depending on geopolitics, ideology, technology, and other factors. Today we may be at another turning point in globalization's history. So what is this powerful force that does so much to influence the world economy? How is it changing? And can it be improved?

Globalization refers to the process of connecting the world economy more closely through the flow of goods, services, investment, technology, data, ideas, and workers. It began around 1870 and took off in the decades after World War II as countries started reducing restrictions on capital and trade flows in anticipation of benefits to growth and welfare.

This process started within geopolitical and regional blocs and later broadened after the fall of the Berlin Wall, financial deregulation, and the rounds of trade liberalization that led to the establishment of the World Trade Organization (WTO) in 1995. It received a further boost from technological developments that reduced the costs of trade and financial transactions. Sea and air transportation became cheaper with innovations such as container shipping, deepwater ports, and jet engines.

Organizational and transactional costs further declined as a result of widespread adoption of information and communication technology—from the introduction of fax machines, to personal computers and mobile devices, to the continuing global rollout of internet connectivity. The world seemed smaller as a result, and doing business across borders became easier.

Upsides and downsides

These developments unlocked a vast latent potential for value creation in the world economy. Production activities were unbundled into multiple stages, allowing each stage of production to take place where it could be done more efficiently. This reorganization of production meant that the same resources could produce more output than before. At the same time, foreign competition prompted companies to become more productive. Consumers, for their part, were able to access a greater variety of goods at more affordable prices.

Most economists think that globalization—and trade reforms in particular—had a positive overall impact on growth, especially for countries that were previously less integrated. Developing economies in particular benefited from contributing to global value chains—sprawling production networks that span the world—because they did not have to develop entirely new domestic industries to export more sophisticated products. During the period of expanding globalization, world income levels converged, and poverty rates decreased from 47 percent in 1980 to 16 percent in 2010.

But globalization had its downsides. Within countries, the shift to a new production structure was sometimes difficult, as workers and capital had to move from one industry to another. Domestic policies, such as labor market support and social insurance programs intended to facilitate this adjustment, differ vastly. Some countries have managed the process better than others. In a number of places and industries, workers—especially those with lower skills—lost their jobs or saw their wages decline. These negative consequences have been concentrated, sometimes harsh, and often prolonged.

Some economists reckon that globalization of finance made the world economy more volatile and crisis-prone. Stronger macroeconomic governance and institutions could help prevent this, they say. Globalization may also have contributed to rising income inequality over the past four decades, but differences in countries' approaches to taxation and redistribution arguably played a greater role, as did technological advances that benefited high-skilled workers and investors.

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Measuring globalization

Traditionally, globalization has been measured by statistics such as trade openness, which is the total value of imports and exports as a share of GDP, or openness to foreign direct investment and policies such as tariffs and capital account restrictions. Other dimensions of globalization are captured by the value of daily cross-border financial transactions or the number of visas for foreign students and workers. Looking at these statistics in aggregate shows that globalization expanded rapidly from the 1980s until the global financial crisis, after which it plateaued. However, this story is overly simplistic given changes to the global economy.

Newer metrics that look at participation in global value chains and trade in services, particularly digital services, show that globalization has actually accelerated in some areas. Traded products increasingly contain value added originating in a variety of upstream countries and sectors. Accounting for this embedded value added is crucial to assessing trade integration and to correctly identifying each country's sectors of relative strength and weakness. A global increase in the foreign value-added content of exports from about 19 percent in the mid-1990s to 28 percent in 2022 points to continued deepening of trade integration.

Meanwhile, services are able to flow more easily across borders thanks to the rise of digital technology. Digitally delivered services, including accounting, design, and media services, already account for 54 percent of services trade, following growth of 8 percent annually over the past two decades. These digital services are a potential future engine for development.

Despite the story these metrics tell about the state of globalization, cracks are emerging. Heightened concerns about national security and supply-chain resilience, punctuated by the COVID-19 pandemic, Russia's war in Ukraine, and an intensification of geopolitical rivalries, have pushed policymakers to shift inward.

Policies at the intersection of trade and national security are being used more broadly, and trade and foreign direct investment restrictions have proliferated, increasing about threefold since 2018. Industrial policy is making a comeback, with trade-disrupting measures affecting at least a fifth of global trade in 2023. Many of these restrictions are inspiring tit-for-tat reactions, increasing tensions between trading partners. The multilateral trading system is ill-equipped to respond, and its credibility is suffering as a result.

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And there are other worrisome trends. Recent studies point to a rotation of trade toward geopolitically closer partners, in particular in strategic sectors. But rather than reducing vulnerabilities, this may simply be lengthening supply chains and increasing costs. Even digital services, a potential bright spot for the global economy, face high levels of policy restrictiveness, which has increased in the past decade.

Sharing the benefits

The benefits of globalization are worth preserving and extending. However, support for continued open economic policies has faced opposition over concerns about inequality, worker dislocations, and unfair competition. Some critics point to overdependence on geopolitical rivals, especially in times of crisis, such as during the pandemic.

Reversing globalization would almost certainly reverse its gains, increase poverty, and result in a costly transition. IMF research shows that global losses from trade fragmentation could range from 0.2 to 7 percent of GDP. The costs may be higher when accounting for technological decoupling. It is therefore critical that policymakers come together to preserve and extend globalization's benefits while also making it more sustainable.

How might policymakers go about this? An essential component is ensuring a well-functioning system of global trade rules, underpinned by the WTO, to maintain trade openness and to ensure the stability and predictability that are so important for trade and growth. This necessarily involves governments working cooperatively to fix underlying sources of trade tensions. Accelerating WTO reforms to strengthen transparency and rules, including on subsidies; restoring a fully functioning dispute settlement system; and updating the rulebook to take into account the growing share of services and digital trade in the global economy are essential.

Plurilateral agreements, among subsets of WTO members interested in deepening cooperation in particular areas, can help advance reforms in e-commerce and investment facilitation without keeping others from joining.

Another critical area for policymakers is stronger domestic policies to share the benefits of trade, globalization, and technological advances more fairly. To be successful, these must be built on solid foundations of sound macroeconomic governance, financial regulation, and supervision to avoid the buildup of risk from financial globalization, and they must include a tax system geared toward efficient revenue mobilization.

Labor market and fiscal policies are key tools for addressing worker dislocations and inequality and are ever-more vital to counter disruptions caused by new technologies, especially artificial intelligence. These policies are complemented by the provision of high-quality basic public services, including education and health and social safety nets.

Finally, international organizations can play a pivotal role in uncertain times, serving as a buffer for unexpected circumstances, promoting commonly agreed-on rules of the road, and acting as a conduit for greater dialogue and cooperation—even when the prevailing winds are blowing in a different direction. F&D

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