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IN DEPTH | GLOBALIZATION IN RETREAT

Whatever Happened to Free Trade?

Companies and countries are scrambling to adjust to a strange new world created by a decade of economic retrenchment and an upswing in populism

By Bob Davis Follow *and Jon Hilsenrath* Follow

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After World War II, the global economy rose on a wave of trade and finance, lifting hundreds of millions of people out of poverty in developing countries and providing rich countries with cheaper goods, lucrative investments and hopes for a more peaceful planet.

That tide is now receding.

Nine years after the financial crisis, global trade is barely growing when compared with overall economic output. Cross-border bank lending is down sharply, as are international capital flows. Immigration in the U.S. and Western Europe faces a deepening public backlash.

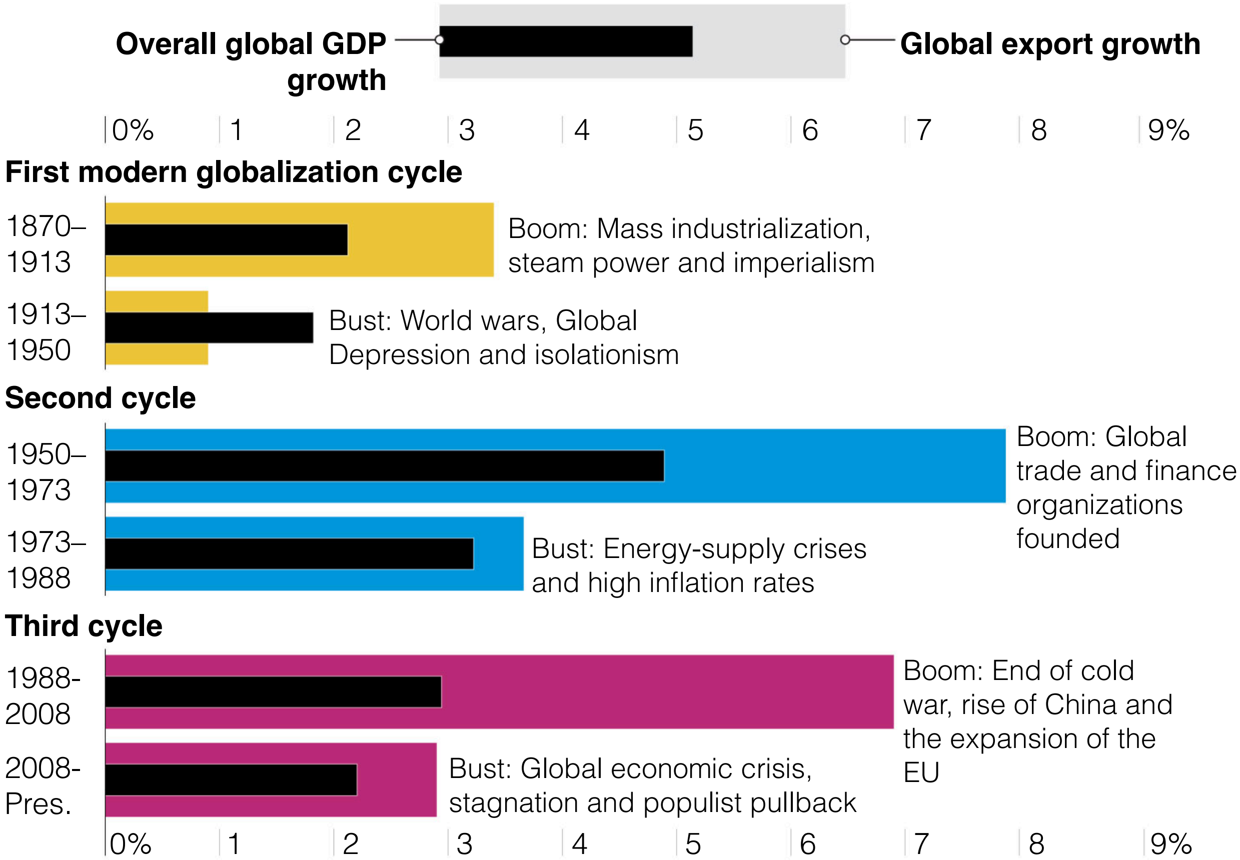
Nationalist politicians are on the ascent. On Wednesday, the U.K. formally started proceedings to remove itself from the European Union. In the U.S., President Donald Trump pulled out of a Pacific trade pact on his first working day in the Oval Office, declaring, "Great thing for the American worker, what we just did."

For traditional economists, globalization is a pathway to prosperity. Rooted in the works of Adam Smith in 1776 and David Ricardo in 1817, the classical canon has embraced the idea that trade is the basis of wealth, because it makes nations more efficient by allowing each to specialize at what its workers do best.

Few of them fully grasped globalization's downsides in a modern economy. Tying together disparate nations economically also expanded the labor pool globally, pitting workers in wealthy nations against poorly paid ones in developing nations. That greatly boosted the fortunes of the world's poor, but also created a backlash in the U.S. and Europe. At the same time, freeing financial flows led to debilitating financial excesses that ended in crisis.

Falling Behind

Globalization, as measured by annualized, inflation-adjusted export and GDP growth, has gone through three distinct cycles. It is now slowing.



Sources: Angus Maddison, IMF, WTO, World Bank and Haver via UBS

"Globalization is in retreat," Larry Fink, the chief executive of the big investment firm BlackRock Inc., said in a February memo to employees, outlining a new corporate strategy. "We need to be German in Germany, Japanese in Japan and Mexican in Mexico."

An earlier era of globalization, which stretched from 1870 to 1913, ended when the world descended into war. Rising trade barriers later played a role in the Great Depression of the 1930s. The present era may not turn out as catastrophically, but nations, companies, multilateral institutions and ordinary citizens are already scrambling to adapt to a world with bigger barriers to trade and finance as blowback builds.

Big banks, such as Citigroup and HSBC, have reduced their global footprints. Industrial firms like General Electric are developing strategies for a more localized world. Guardians of globalization, like the World Trade Organization, struggle with challenges from China and other emerging powers. Poor nations are finding it harder to count on exports for economic development. Wealthy nations face less hospitable overseas markets, while their workers grapple with the demands of automated workplaces.

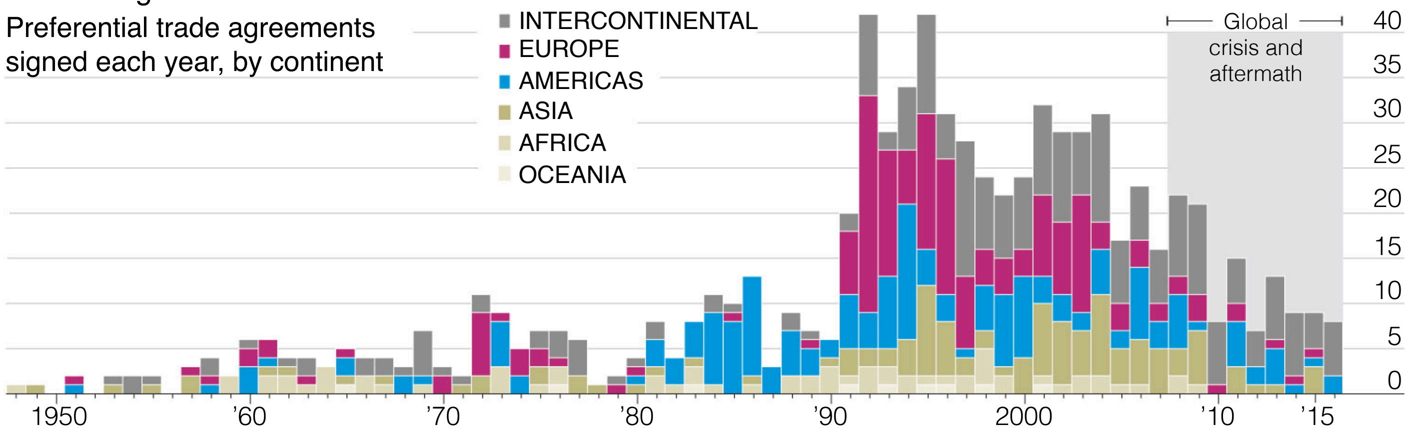
Critics of globalization say a slowdown in cross-border trade and finance will help ease pressure on wages of unskilled workers in wealthy nations, stem the threat of financial bubbles and reduce the influence of multinational companies in developing nations.

"Maybe the U.S. will supply more of its demand by itself," said Clyde Prestowitz, president of the Economic Strategy Institute in Washington, D.C., who has long urged the U.S. adopt more aggressive trade policies. "That could be a good thing and create jobs."

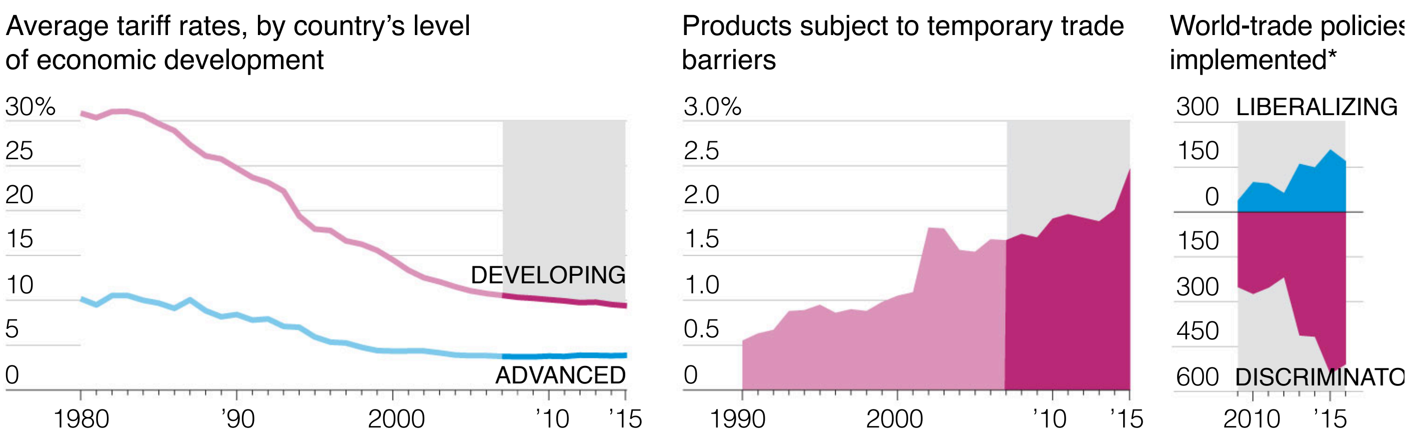
During the globalization epoch that started after World War II, trade growth usually far outpaced—and helped drive—overall economic output. Now it is barely keeping up. The slowdown has long outlasted the financial crisis of 2007 to 2009, which helped set it off. Between 2011 and 2015, the value of global merchandise exports contracted 10%, according to the WTO, the largest drop over a four-year period in post-World War II history, driven in part by tumbling commodities prices. Merchandise export growth over a 10-year time frame is also the slowest of this era.

Waning Enthusiam

The sustained surge of international agreements that followed the Cold War has tapered significantly since the global financial crisis.



As popular sentiment has turned against globalization, the steady reduction in tariff levels has stalled and many countries have turned to protectionist measures.



*Counts policies documented between Jan. 1 and Oct. 31 of a given year to correct for reporting lags.

Sources: Design of Trade Agreements Database (agreements); IMF and World Bank (tariff rates); World Bank (trade barriers); Global Trade Alert (policies)

"We have a deflationary mind-set," Jakob Stausholm, chief financial officer of Maersk, the Danish shipping giant, told investors in February, while reporting a $1.9 billion loss. A few days earlier a court in Seoul declared that Hanjin Shipping Co., the world's seventh-largest shipper, was heading for liquidation.

Among the hottest trends in the industry last year was the dismantling of giant container ships for scrap metal—862 in all—along the beaching yards of Pakistan, Bangladesh and India.

Annual movement of capital across borders—in the form of stock and bond purchases, foreign direct investment and lending—fell more than two-thirds, to $3.3 trillion in 2015 from $11.9 trillion in 2007, according to McKinsey & Co. Overseas bank lending, particularly from Europe, has been hard hit. The stock of cross-border loans held at banks around the world contracted 21%, from $35.5

trillion in 2008 to $28.2 trillion in the third quarter of 2016, according to the Bank for International Settlements.

The ship-breaking business is booming in Pakistan as surplus container vessels are decommissioned.
PHOTO: PPI/ZUMA PRESS

Peterson Institute for International Economics trade economist Gary Hufbauer calculates that U.S. output in 2016 was $2 trillion greater than it otherwise would have been thanks to greater trade and financial integration since 1950. Slowing the pace of globalization will actually slow U.S. income gains, he argues.

No less is at stake for a country such as Ethiopia, which has averaged growth rates in excess of 10% for the past decade as part of a push toward industrialization and greater international exposure. The country has little to fall back on if its globalization bet sours.

Hoping to emulate China's ride on the globalization wave, Ethiopia is building a half-dozen manufacturing zones to produce garments, textiles and shoes for multinational firms, along with railroads and power plants. The construction spree, which keeps the air in Addis Ababa thick with dust, has created rising external debt loads, which jumped from $2.3 billion in 2006 to $20.4 billion in 2015, according to the World Bank.

Ethiopia's prime minister, Hailemariam Desalegn, says the debt is a price he is willing to pay. "If you want to move in an easy way, then you can't achieve double-digit growth," he said in a recent interview. "We have to carefully manage it, but there is a way out also. We have a huge potential in terms of exports."

The lethargic recovery from the global recession, especially weak demand for capital goods and big investment projects, helps to explain the global trade slowdown.

A garment factory in Ethiopia, which is betting heavily on global trade to lift its economy. PHOTO: PETTERIK WIGGERS/PANOS PICTURES FOR THE WALL STREET JOURNAL

Protectionism is another cause. Global Trade Alert, a trade monitoring group, counts nearly 7,000 protectionist measures enacted world-wide since the recession of 2009. About half of the items are aimed at China.

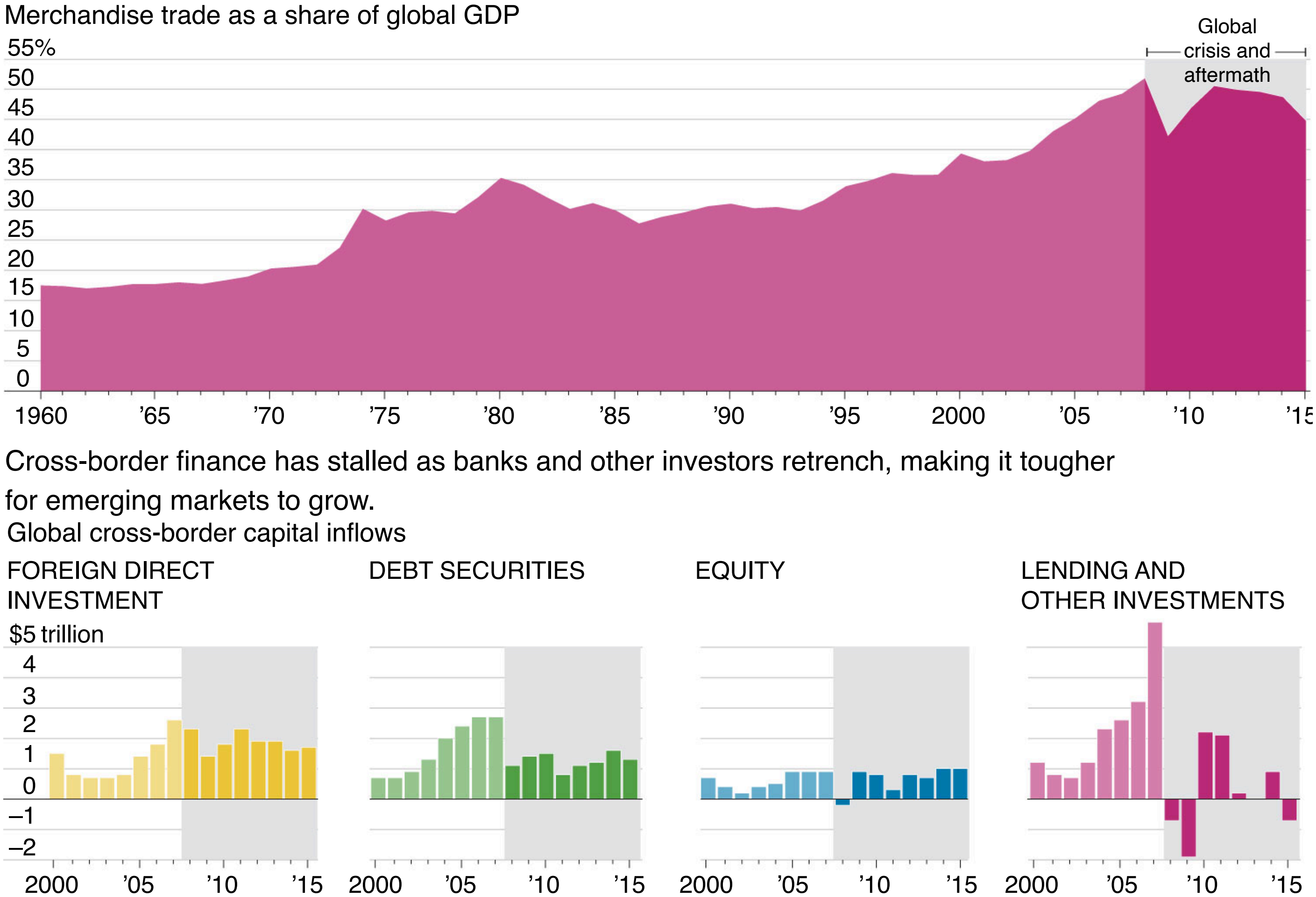
It has been 23 years since the completion of the last global trade deal in 1994 and no other is on the horizon. Since 2008, the International Monetary Fund reports, tariff reductions have been "minimal," after falling by about 1 percentage point a year between 1986 and 1995 and 0.5 percentage points annually for the following 13 years.

Multinational companies used the 1990s and 2000s to build global supply chains—for instance linking rubber plantations in Malaysia to tire manufacturers in China and retailers in the U.S., or coffee growers in Colombia to Starbucks restaurants.

These webs of commerce supercharged trade but have begun to retrench, as companies localize their production and import fewer components for assembly. The World Bank says global supply chains stopped growing around 2011, after expanding about 4% annually for the previous two decades.

Slowing Flow

After decades of growth, the global flow of goods and finance has begun to reverse.



Sources: World Bank (trade to GDP); IMF via McKinsey Global Institute (capital flows)

General Electric Corp, which since the 1980s has expanded its global footprint, says it's time for a "bold pivot" in strategy to focus on regional centers. In explaining the move last year, GE Chief Executive Jeff Immelt said he would prefer to operate by free-trade principles, but "a localization strategy can't be shut down by protectionist politics."

In practice, that means GE is building up its manufacturing capacity in China and India and other big markets to supply customers there, rather than counting on exports and global links. As part of the strategy, GE signed a deal in 2015 to build locomotives in India, rather than relying on a global production site in the U.S., as it once did.

Surveying the global economy from Beijing, where he co-owns eight electronics and medical equipment factories, Dwight Nordstrom, chairman of Pacific Resources International LLC, says he is "waiting to see how the politics shake out" before building any Chinese plants aimed at the export market.

That’s because local-content rules may require firms like his to build factories in different countries. “We may be forced to have more factories than makes economic sense,” he says.

China, once an assembly platform that sucked in commodities and manufactured goods from abroad, put them together and reshipped them, is now producing much of what it needs domestically.

Benjamin Dolgin-Gardner, founder of Hatch International Ltd., an electronics manufacturer in Shenzhen, China, says he now uses Chinese-made LCD screens rather than ones made elsewhere in Asia for the tablets he produces. Memory chips for MP3 players are also made in China rather than imported from Japan and South Korea.

“China is increasingly cannibalizing supply chains,” says Alex Wolf, a London economist at the investment firm of Standard Life Investments, reducing exports from Korea, Taiwan and other nations whose economies are tightly linked to China’s.

The reaction to the financial crisis in many countries included new banking rules, adopted globally, which require banks to hold bigger capital buffers against securities and loans. That has cut into their willingness to take risk across borders.

Regulators in China, Cyprus, Iceland, Brazil and other countries imposed capital controls to limit the waves of potentially destabilizing money washing into and out of their financial systems. In all, 31 out of 108 countries tracked by economists Menzie Chinn and Hiro Ito became less open to global capital flows between 2008 and 2014, while 13 became more open.

That’s a sharp reversal from the five-year precrisis period, when 40 countries became more open to global capital flows and 12 became less open.

China, once merely an assembly platform for global trade, is now producing much of what it needs domestically. Here, workers make components for mobile phones. PHOTO: STR/AGENCE FRANCE-PRESSE/GETTY IMAGE

Europe is the epicenter of the global lending crunch. Hungary privatized most of its banks after the fall of Communism in 1989, drawing investors from Austria, Italy, Belgium and beyond. By the mid-2000s, Hungarian homeowners had become avid consumers of mortgages issued by Austrian banks denominated in Swiss francs, emblematic of the rapid globalization of European finance.

After the financial crisis, the Swiss franc soared, pushing up the cost of those mortgages. Nearly one-third of Hungarian borrowers went 90 days or more delinquent on their mortgages, inviting a political backlash.

Viktor Orban's nationalist Fidesz party won parliamentary elections with a landslide in 2010 and Mr. Orban set out to increase Hungarian ownership of the banking sector to at least 50%. His administration imposed taxes and fees on the sector and demanded banks convert Swiss franc loans into local currency denominations. Foreign bank lending contracted for eight straight years through 2016, according to the Institute for International Finance, a banking trade association in Washington.

As foreign banks departed, the country's economy minister, Mihaly Varga, told local reporters that the policy "boosts economic sovereignty." A 2016 review by the IMF, while lauding Hungary's rebound from the recession, said the government had simply shifted risks from private hands to the public sector, because the Hungarian government took big stakes in banks and other companies.

In wealthy nations, the big hope is that a reversal in globalization will lift wages of unskilled workers by reducing competition from low-wage nations. That hasn't been the case so far. Globally, wage growth slowed to an average 2.1% in the past five years, compared with 2.4% in the five years leading up to the 2007-2009 financial crisis, according to the International Labor Organization.

In the U.S., wages and salaries of workers rose 2% a year in the past five years. That's down from 2.9% in the five years before the crisis.

That hasn't stilled globalization's many critics. "Globalization has made the financial elite who donate to politicians very, very wealthy," Mr. Trump said last June at a Rust Belt stop in Pennsylvania, "but it has left millions of our workers with nothing but poverty and heartache."

—Matina Stevis, Anjani Trivedi and Margit Feher contributed to this article.

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