Economic policy in a changing world

All governments, until not too long ago, had high expectations about globalisation, thought to mean the dynamic integration of the world economy.

Globalisation was expected to lift global growth and welfare as the world's resources were organised more efficiently. As countries became richer, more open and more market-oriented, democratic values and the rule of law would spread. And all this would make emerging economies more productive participants in multilateral institutions, thereby further legitimising the global order. The prevailing mood was well-captured by George H.W. Bush in 1991, when he said that "no nation on Earth has discovered a way to import the world's goods and services while stopping foreign ideas at the border."[1]

This virtuous circle would also lead to "equality by default" in the sense that no specific government policy would be needed to achieve it. Rather, we would have a harmonious convergence towards higher living standards, universal values and international rule of law.

There is no doubt that some of these expectations were borne out. The opening of global markets brought dozens of countries into the world economy and raised billions of people out of poverty – 800 million in China alone over the past 40 years. It generated the broadest and fastest improvement of living standards ever witnessed in history.

But our model of globalisation also contained a fundamental weakness. For open markets between countries to be sustained, there must be international rules and dispute settlements with which all participating countries comply. But in this new globalised world, the commitment of some of the largest trading partners to play by the rules was ambiguous from the start. Unlike in the EU single market, where compliance is intrinsic, being enforced by the European Court of Justice, the international organisations created to supervise the fairness of global trade were never given equivalent independence and powers.

So, the globalised world trade order was always vulnerable to a situation where any country or group of countries could decide that following the rules would not serve their near-term interests.

To give just one example, during the first 15 years of its WTO membership, China failed to notify any sub-central government subsidies to the WTO, despite the fact that most subsidies are provided by provincial and local governments.[2] And this non-compliance had been known for years: as early as 2003, it was being noted that China's WTO implementation efforts had "lost a significant amount of momentum",[3] but indifference prevailed and nothing substantive was done to address it.

The consequences of this weak compliance were economic, social and political.

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[1] Remarks at Yale Commencement Ceremony, New Haven, Connecticut, 27 May 1991.

[2] United States Trade Representative (2023), "2022 Report to Congress On China's WTO Compliance", February.

[3] United States Trade Representative (2003), "2003 Report to Congress On China's WTO Compliance", December.

Globalisation led to large trade imbalances, the consequences of which policymakers were slow to recognise. These imbalances arose in part because trade opening was happening between countries at very different levels of development, which limited the capacity of poorer countries to absorb imports from richer ones, and gave them justification to protect infant industries from foreign competition.

But they also reflected deliberate policy choices in large parts of the world to build trade surpluses and constrain market adjustment.

After the 1997 crisis, East Asian economies used trade surpluses to build up large currency reserves and self-insure against balance of payments shocks, mainly through preventing exchange-rate appreciation, while China pursued a deliberate long-term strategy to wean itself off dependence on the West for capital goods and technology.

After the 2011 eurozone crisis, Europe also pursued a policy of deliberately accumulating current account surpluses, although in this case through the misguided procyclical fiscal policies enshrined in our rules that depressed domestic demand and labour costs. In a situation where EU solidarity mechanisms were limited, this stance might even have been understandable for countries dependent on external financing. But even those with strong external positions, such as Germany, were part of the trend.

These policies meant that the current account of the euro area shifted from broadly balanced before the crisis to a high of more than 3% of GDP in 2017. At this peak, this was in absolute terms the largest current account surplus in the world. As percentage of world GDP, only China in 2007-08 and Japan in 1986 have had a higher surplus.

Together, surplus accumulation led to an increase in global excess savings and a decline in global real rates, a phenomenon noted by Ben Bernanke already in 2005.[4] And this was not matched by higher demand for investment. Public investment fell by almost two percentage points across G7 countries from the 1990s to the 2010s, while private sector investment stalled once firms deleveraged after the great financial crisis.

This fall in real rates contributed substantially to the challenges experienced by monetary policy in the 2010s, when nominal interest rates became pressed at the lower bound. Monetary policy was still able to generate employment through unconventional measures and produced much better outcomes than some had expected. But these measures were not sufficient to fully remove labour market slack.

The social consequences manifested themselves in a secular loss in bargaining power for labour in advanced economies, as jobs were displaced by offshoring or wage demands contained by the threat of it. In G7 economies, total exports and imports of goods increased by around 9 percentage points from the early 1980s to the great financial crisis, while the labour share of income dropped around 6 percentage points in that time. This was the steepest drop since data for these economies began in 1950.

The political consequences followed. Faced with tepid labour markets, declining public investment, a falling labour share and offshoring of jobs, large segments of the public in Western countries justifiably felt they had been "left behind" by globalisation.

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[4] Bernanke, B. (2005), "The Global Saving Glut and the U.S. Current Account Deficit", remarks at the Sandridge Lecture, Virginia Association of Economists, Richmond, Virginia.

As a result, contrary to initial expectations, globalisation not only failed to spread liberal values, because democracy and freedom do not necessarily travel with goods and services, but also weakened them in the countries that were its strongest proponents and fed instead the rise of inward-looking forces. The perception in the public in the West became that ordinary citizens were playing in a flawed game, one that had displaced millions of jobs, while governments and corporate sector remained indifferent.

In place of the traditional canons of efficiency and cost optimisation, people wanted a fairer distribution of the benefits of globalisation and a greater focus on economic security. And to deliver these outcomes, more active use of "statecraft" – be it assertive trade policies, protectionism or redistribution – was expected.

A series of events then reinforced the trend. First, the pandemic underlined the risks of extended global supply chains for essential goods like medicines and semiconductors. This understanding led to the shift in many Western economies towards re-shoring of strategic industries and bringing critical supply chains closer.

The war of aggression in Ukraine then caused us to re-examine not only where we buy goods, but from whom. It highlighted the dangers of excessive reliance for essential inputs on large, untrustworthy trading partners that threaten our values. Now, everywhere we are seeing security of supply – of energy, rare earths and metals – rising up the policy agenda.

This shift is being reflected in the emergence of blocs of nations that are largely defined by their common values, and it is already leading to meaningful changes in global trade and investment patterns. Since the invasion of Ukraine, for example, trade among geopolitical allies has grown by 4-6% more than trade with geopolitical adversaries.[5] The share of FDI taking place among geopolitically aligned countries has also been rising.[6]

And, all the while, the urgency to address climate change has increased. Achieving net zero in an ever-shortening time frame requires radical policy approaches in which the meaning of sustainable trade is being re-defined. The US Inflation Reduction Act and, in prospective, the EU's Carbon Border Adjustment Mechanism both prioritise climate security objectives over what were previously seen as distortionary effects on trade.

This period of profound change in the global economic order comes with equally profound challenges for economic policy.

First, it will change the nature of shocks to which our economies are exposed. During the last thirty years, the main sources of disruption to growth were demand shocks, often in the form of credit cycles. Globalisation did cause a continuous stream of positive supply shocks, in particular by adding tens of millions of workers every year to the tradeable sector in emerging economies. But those changes were by and large smooth and continuous.

Now, as China moves up in the value chain, it will not be replaced by another exporter of global labour market slack. Instead, it is likely that we will experience more frequent, lumpier and also larger negative supply shocks, while our economies adjust to this new setting.

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[5] WTO (2023), *World Trade Report 2023: Re-globalization for a secure, inclusive and sustainable future*.
[6] Aiyar, S. et al. (2023), "Geopolitics and the cost of FDI fragmentation", in Aiyar, S. et al. (eds.), *Geoeconomic fragmentation: the economic risks from a fractured world economy*, CEPR, 2 October.

These supply shocks are likely to emanate not only from new frictions in the global economy, such as geopolitical conflicts or natural disasters, but even more so from our policy response to mitigate those frictions. We need to invest an enormous amount in a relatively short time horizon to restructure supply chains and decarbonise our economies, with capital being likely destroyed faster than it can be replaced.

In many cases, we are investing not so much to add to the capital stock as to replace capital that is being made obsolete by a changing world. To illustrate this point, think of the LNG terminals that were built around Europe over the past two years to relieve the over-reliance on Russian gas. That was not investment intended to increase the flow of energy in the economy, but rather to maintain it.

Investing in decarbonisation and supply chains should raise productivity in the long run, especially if it entails greater adoption of technology. But it implies temporarily reduced aggregate supply while resources are reshuffled within the economy.

The second key change to the macroeconomic landscape is that fiscal policy will be called upon to play a greater role, meaning – I expect – persistently higher public deficits. The role of fiscal policy is classically divided into allocation, distribution and stabilisation, and on all three fronts the demands on government spending are likely to increase.

Fiscal policy will be called on to step up public investment in order to meet the range of new investment needs. Governments will have to address wealth and income inequality. And, in a world of supply shocks, fiscal policy will likely have to play a greater stabilisation role as well – a role we had previously mainly assigned to monetary policy.

We assigned monetary policy that role precisely because we were mostly facing the type of demand shocks that central banks can deal with. But a world of supply shocks makes monetary stabilisation more difficult. The lags of monetary policy are typically too long either to restrain supply-driven inflation or offset the resulting economic contraction, meaning monetary policy can at best focus on limiting second-round effects.

So, fiscal policy will naturally be called on to play a greater role in stabilising the economy, as fiscal policies can mitigate the effects of supply shocks on GDP with a shorter transmission lag. We already saw this during the energy shock in Europe where subsidies compensated households for about one-third of their welfare loss[7] – and in some EU countries, such as Italy, they offset up to 90% of the loss of purchasing power for the poorest households.

Taken together, these changes point towards lower potential growth as the adjustment processes play out and to an outlook of more volatile inflation, with new upward pressures emerging from economic transitions and from persistent fiscal deficits.

Furthermore, we have a third change: if we are entering an era of greater geopolitical rivalry and more transactional international economic relations, business models based on large trade surpluses may no longer be politically sustainable. Countries that want to keep

[7] Amores, A. F., Basso, H.S., Bischl, S., De Agostini, P., De Poli, S., Dicarlo, E., Flevotomou, M., Freier, M., Maier, S., García-Miralles, E., Pidkuyko, M., Ricci, M. and Riscado, S. (2023), "Inflation, fiscal policy and inequality: The distributional impact of fiscal measures to compensate consumer inflation", ECB Occasional Paper Series No. 330.

exporting goods may have to be more willing to import other goods, or services, to earn that right – or they will face increasing retaliatory measures.

This change in international relations will affect the global supply of savings, which will either have to be reallocated towards domestic investment or reduced by a fall in GDP. In both scenarios, the downward pressure on global real rates that has marked much of the era of globalisation should be reversed.

These changes carry consequences for our economies which are still highly uncertain. But likely area of change will be in our macroeconomic policy architecture.

To stabilise growth potential and reduce inflation volatility, we will need a change in overall policy strategy – one that focuses both on completing the ongoing supply-side transitions and spurring productivity growth, where the extensive adoption of AI could help.

But to do all this at speed will require an appropriate policy mix: a sufficiently low cost of capital to frontload investment spending, financial regulation that supports capital reallocation and innovation, and competition policy that facilitates state aid where it is justified.

One of the implications of this strategy is that fiscal policy is likely to become more sensitive to monetary policy. In near term, whether fiscal policy will have sufficient policy space to deliver on its various goals will depend on central banks' reaction functions. And looking further ahead, if potential growth stays low and public debts remain at record highs, debt dynamics will be mechanically affected by the higher level of real rates.

This means that demands for policy coordination are likely to increase, which is something our macroeconomic policy architecture is not designed to deliver. In fact, this architecture purposely assigned several important policy functions to independent agencies, operating at arms' length from governments, so that they could be insulated from political pressures – and this has no doubt contributed to long-term macroeconomic stability.

However, it is important to remember that independence does not have to mean separation, and different authorities can join forces to increase policy space without compromising their mandates. We saw this during the pandemic when monetary, fiscal and banking supervisory authorities joined forces to limit the economic damage of lockdowns and prevent a deflationary slump. This policy mix allowed both authorities to achieve their goals more effectively.

Likewise, in today's conditions a consistent policy strategy should have at least two elements.

First, there must be a clear and credible fiscal path ahead that focuses on investment while – in our case – preserving European social values. This would give greater confidence to central banks that public spending today, by increasing supply capacity, will lead to lower inflation tomorrow.

In Europe, where fiscal policies are decentralised, we can also take a step further by financing more of this investment collectively at the Union level.[8] Issuing common debt to finance investment would enlarge the collective fiscal space we have available, which would relieve some of the pressures on national budgets. At the same time, as EU spending is more programmatic – often running over multiple years – carrying out investment at that level would provide a stronger commitment that fiscal policy will ultimately be non-inflationary, which central banks could reflect in their medium-term inflation outlook.

Second, if fiscal authorities were to set out credible fiscal paths in this way, central banks should ensure that the primary compass for their decisions is inflation expectations. Monetary policy will face a challenging environment in the years to come, in which, more than ever, it will have to distinguish between temporary and permanent inflation, between catch-up wage growth and self-fulfilling spirals, and between the inflationary consequences of good and bad public spending.

In this setting, an accurate measurement of, and meticulous focus on, inflation expectations is the best way to ensure that central banks can contribute to an overall policy strategy without compromising on price stability or independence. This compass precisely allows to delineate temporary upward price shocks, such as relative price shifts between sectors or higher commodity prices related to higher investment, from risks of generalised inflation.

We need policy space to invest in the transitions and increase productivity growth. Economic policies need to be consistent around a common strategy and set of objectives. But finding the path for such policy alignment will not be easy.

The transitions that our societies are undertaking, whether dictated by our choice to protect the climate or the threats of nostalgic autocrats, or by our indifference to the social consequences of globalisation, are profound. And differences between possible outcomes have never been so stark.

But people know at heart the value of our democracy and what it has given us over the last eighty years. They want to preserve it. They want to be included and valued within it. It is up to leaders and policymakers to listen, understand and act together to design what is our common future.

[8] See Draghi, M. (2023), "The Next Flight of the Bumblebee: The Path to Common Fiscal Policy in the Eurozone", 5th Annual Feldstein Lecture.