Emerging fault lines in the global economy: a small advanced economy perspective

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Introduction

The norms, ideas and institutions that have provided the foundation for the global economic system for decades are under pressure. Consider the protectionist rhetoric in the US Presidential campaign; the increasing challenges facing European integration, most obviously in the Brexit vote; and the increasingly explicit role of geopolitics in shaping international commerce, including trade agreements such as the Trans-Pacific Partnership.

This may not yet amount to a reversal of globalisation, but it is a marked step away from the hyper-globalisation of the past 25 years – a period of very strong growth in cross-border trade and investment. To better understand the emerging fault lines in globalisation, and the potential for disruptive change, it is instructive to look at the experience of small advanced economies: countries such as New Zealand, Singapore, the Nordics, Switzerland and the Netherlands.

As I noted in the Spring/Summer 2013 issue of Global Brief, small advanced economies have long acted as a good barometer of the health and functioning of the global economic system. Because they are acutely exposed to the global economy, emerging global dynamics show up cleanly and quickly in small advanced economies. Small advanced economies have prospered in an era of intense, rules-based globalisation, but the recent small country experience highlights a much more challenging political economy of globalisation.

Small countries are reflecting a global context that has much in common with the 1970s, a period of slowing, volatile growth, domestic political unrest, and a fluid international economic system. For the most part, small advanced economies are responding quickly and creatively to this emerging global environment. And yet the scale and nature of the emerging fault lines in the global economic system, and the potential for a rupture, commend themselves to an aggressive watching brief.

Small advanced economies illustrate the emergence of three fault lines in the global economy: increased domestic economic and political pressures from globalisation; challenges to existing models of regional economic integration; and a more explicit interaction between international economics and politics.

The domestic politics of globalisation

Small advanced economies benefited enormously from the intense process of globalisation over the past 25 years. The high, growing exports and outward investment shares, and the successful activities of small country multinational companies, have supported strong economic performance by small countries.

The strategic posture of most small countries is deeply outwardly-oriented, aimed at building positions of competitive advantage through high quality policy settings, investing in innovation, and so on. Small countries have also acted to ensure these economic benefits are broadly shared, by investing heavily in education and building strong social insurance systems. Relative to larger economies, small countries have managed globalisation well. This policy approach has helped to sustain solid public support for openness and globalisation.

But the experience of globalisation in small countries is changing in ways that are weakening public support for openness and requiring different policy approaches. For example, strong migration rates are placing pressure on labour markets and infrastructure in several small countries. Some governments are responding with increasingly tough stances on migration, with referenda in Switzerland on restricting migration and Singapore imposing tighter controls on migration. In Europe, from Austria to the Nordics, these pressures have been exacerbated by large refugee inflows.

Similarly, ultra-loose monetary policy in the US and the Eurozone is having disruptive spillover effects on small economies, leading to strongly appreciating exchange rates (Switzerland, New Zealand), rapidly appreciating property prices (the Nordics, New Zealand), and low or negative inflation rates (Singapore, Denmark). This is placing enormous pressure on small country policy-makers, as they try to deliver strong growth rates, target inflation rates, as well as financial stability. In response, small countries, from Switzerland to Israel and Singapore to New Zealand, are intervening more actively in foreign exchange markets and establishing restrictions on foreign ownership.

There are also indications of increased small country resistance to international liberalisation in services sectors. In New Zealand, for example, there has been a surprisingly high level of protest against specific aspects of the TPP deal – such as the investor-state dispute settlement mechanism – as well as against liberalisation in a general sense.

The instinctive small country support for globalisation is weakening as global engagement presents increasingly material challenges and risks to growth, employment and asset prices. That these behaviours are observed consistently across quintessentially open small economies, which have benefited substantially from globalisation, suggests structural changes in attitudes towards globalisation. This is more than concern about globalisation from the usual suspects.

Small country governments are responding with a more managed approach that allows them to exercise more policy discretion in areas that are economically or politically important. But this is a tough balancing act. And in larger countries, from France to the UK and the US, there is frequently a less calibrated response, with a more protectionist sentiment, as they respond to global forces that are reaching further inside their domestic economies.

Challenges to regional integration

An important driver of globalisation over the past few decades has been regional integration: 70% of Europe's trade is intra-regional in nature, 60% of North America's, and 50% of Asia's. The formal regional arrangements in the US, Asia and the Americas, such as the EU, ASEAN and NAFTA, together with the connective tissue of regional supply chains and infrastructure networks, have provided a strong regional base for globalisation. Indeed, globalisation remains heavily regionally organised.

Small countries have long placed regional economic integration at the centre of their economic strategies. In Europe, of course, the Benelux countries were founding members of the six- strong European Economic Community. Subsequently other small European countries became very active participants in the EU. For its part, ASEAN is a central element of Singapore's external strategy. Indeed, only two small countries have developed into advanced economies without deep integration into their respective regional economies: New Zealand for geographic reasons, and Israel for geopolitical reasons. But for most small countries, regional economic integration is a strategic imperative.

In this context, it is striking that small countries have been at the forefront of challenging more intensive European regional engagement. Northern European economies such as the Netherlands have long been signalling frustration with the EU on issues such as the patchy application of economic and fiscal rules as well as the bail-outs of countries like Greece. Other recent examples include Iceland suspending EU membership negotiations, the latest No vote in a Danish referendum in 2015 on removing its opt-out of several EU home and justice policy matters, the 2014 Swiss referendum vote to impose limits on immigration, and Finland's foreign minister suggesting last December that Euro membership had been a mistake for Finland. The Austrian presidential election result in May of this year – now to be rerun in October – was another signal of increased nationalism in a small European country.

Tighter regional integration is being challenged by a desire for greater domestic policy autonomy to respond to issues in ways that reflects the local context, as well as by associated concerns about the political legitimacy of decision-making at the centre. There is little small economy appetite for formal European integration – that is, into an economic or fiscal union, or into some deeper federal framework. Rather, there is a consistent view in small northern European countries on EU reform, which emphasises a looser model of integration based on the primacy of nation states, clear rules and a liberal approach.

Small economies are not decoupling from their respective regions in response to these emerging political pressures, but are trying to alter the balance between domestic and regional-level policy autonomy. In contrast, larger economies are more prone to push for a more federalist model with central decision-making (France) or to completely separate in a quest for national sovereignty (such as the UK's Brexit vote). Small economies see both approaches as containing fundamental dangers.

Although post-Brexit opinion polls in several small countries confirm ongoing strong support for EU membership, the small economy experience clearly indicates that there are fault lines emerging in regional integration. If this pressure is not well managed by the EU member states, both individually and collectively, it could lead to institutional unravelling that weakens the global economy.

The return of geopolitics

The liberal, rules-based global economic system that has prevailed over the past several decades has helped to separate international commerce from the projection of political power. However, the demarcation between international economics and politics is becoming less clear. The weakening of multilateral institutions means that trade liberalisation increasingly occurs on a regional or bilateral basis, which elevates political considerations. And the transition to a multipolar world, in which major economic players like the US and China have differences in their strategic preferences, exposes the functioning of the global economy to geopolitical considerations. In Asia, overlapping trade deals (TPP, the Regional Comprehensive Economic Partnership) and development institutions like the Asian Infrastructure Investment Bank (AIIB) are just some recent examples of this.

These developments create specific exposures for small advanced economies. This is most obviously true in negotiating trade agreements, where the ability of small countries to secure agreements is constrained by their limited domestic market size. But more importantly, these negotiations also necessarily expose small advanced economies to the strategic preferences of larger countries. For example, New Zealand signed a free-trade agreement with China in 2008, partly on the back of New Zealand's early willingness to grant China 'market economy' status at the WTO. However, New Zealand has not secured a bilateral deal with the US, reflecting the challenged relationship with the US since exiting the ANZUS alliance in the 1980s.

In addition, small countries can also be squeezed by larger countries. I have written in these pages about the risk exposures inherent in the asymmetric relationship between small and large countries such as New Zealand and China (see my In Situ article in the Fall/Winter 2015 issue of Global Brief). This is also true in many other bilateral relationships; for example, between several of the ASEAN countries and China. Small advanced economies increasingly have to deliberately balance economic and broader strategic interests, which imposes economic costs.

Small advanced economies are also exposed to the spillover effects of strategic economic competition between large countries. Increasingly, international economic engagement by large countries, such as the TPP and Transatlantic Trade and Investment Partnership (TTIP), is framed in geostrategic terms. A primary stated source of value of the TPP to the US is to set the rules of the game on a basis acceptable to the US and to represent the economic arm of the pivot to Asia. But many small economy members of the TPP value the agreement for economic reasons and do not want it to become part of a binary strategic choice between the US and China.

Small countries are also affected by the increased willingness of large countries to take unilateral action. For example, the US tendency towards extra-territorial jurisdiction on tax and financial sector issues has impacted small economies such as Switzerland. And the increasing noise in the US with respect to imposing sanctions on 'currency manipulators' or countries with sustained current account surpluses is another example of the potential unilateral use of power in the global economic system. For its part, Russia's annexation of Crimea sent clear warning signals to smaller NATO border countries like Estonia, Latvia and Lithuania, as well as neutral small countries like Sweden and Finland.

Better than most, small advanced economies appreciate the impact that geopolitical frictions are already having on globalisation, and how marked a change this is from the past few decades. Small countries in Asia, such as New Zealand and Singapore, and in Europe, such as Finland and the Netherlands, have first-hand experience of these emerging challenges. They are responding through a combination of strategic balancing and hedging, but major exposures remain. The increased willingness of large countries to pursue strategic goals through international economic policy is a significant risk to an open global economy.

Earthquakes ahead?

Small advanced economies around the world, the canaries in the mine of the global economy, are reflecting the emergence of new fault lines in the global economy. The impact of the pressure from moving tectonic plates depends importantly on how it is managed by national government policy-makers. A careful release of pressure through calibrated policy may lead the global economy to a better, more sustainable position. Alternatively, growing pressure could cause fault lines to rupture – causing significant damage.

For the most part, small advanced economies are remaining open even as they manage international economic integration to respond to domestic economic and political challenges. This is reminiscent of the 'embedded liberalism' aspiration of the design of the original Bretton Woods system, in which an open, liberal international economic system was designed to be consistent with a measure of domestic political autonomy. For at least a few decades after 1945, this system underpinned rapid growth in cross-border trade and investment while retaining political legitimacy.

Positively framed, this may suggest that the basic structure of the global economy system can be maintained even with a more challenging political economy. Indeed, this small country policy response may be relevant to larger countries in terms of how to respond to the new fault lines.

And yet the small country experience also suggests a less encouraging set of implications. The depth of current concern in small economy capitals in Asia and Europe about the outlook for the global economic system – with the rise of protectionism, the weakening of regional integration, and the use of political power in the international economic system – should be understood and taken seriously.

The type of global economy that develops will rest heavily on how large countries respond to these emerging pressures. But large countries place less weight on the external economy, and have less of an imperative to balance domestic political concerns with international engagement in a way that preserves openness.

It seems unlikely that a Bretton Woods 2.0 will emerge. Post-crisis international coordination has been patchy, with domestic interests consistently prioritised over the global system. The US and China do not at present have aligned interests or perspectives, and international institutions such as the IMF and G20 are not well-placed to lead on a new consensus.

Rather, there are indications of a tilt towards more inwardly-oriented policies in large advanced economies (the US) and emerging markets (China and Russia). And Brexit is an ominous warning sign that public support for a liberal, open system may be weakening quickly, and that the system is more fragile than it has been assumed to be. There is a growing likelihood of rupture along the new faultlines.

Although, absent future great wars, it is not possible to put globalisation back in the bottle, it can be significantly diminished. The 1970s provides a useful historical analogy. Four decades ago, economic and political stress after the ending of a period of sustained global growth led to the dismantling of the

Bretton Woods exchange rate system, the rise of protectionism, and competitive international behaviour (OPEC, as well as competitive devaluations).

Today, the potential for similarly costly developments is unfortunately high. Indeed, the protectionist dangers of a possible Trump Presidency, uncoordinated loose monetary policy leading to currency wars, and the unwinding of the EU project – now further complicated by the growing stability in Turkey and also Ukraine, both at the edges of the EU – are all readily identifiable risks. Taken further, the prospect of system-wide protectionism and tariff competition, the development of competing rather than open regional blocs, and the 'weaponising' of international economic policy, are all plausible. And in this febrile environment, black swan events are perhaps more likely.

In response, large-country decision-makers, as well as those in global institutions such as the IMF, would do well to better involve small countries in these policy debates. There is much that can – and should – be learned from small countries in terms of how to better manage globalisation in these more challenging times. And small countries can play a valuable part in highlighting the costs and risks of inwardly-oriented policies, as well as challenging larger economies to perform a global stewardship role.

From a small economy perspective, the global economy is as complex and challenging as it has been in decades. It is no time for complacency, nor is it time to assume that the world will proceed in a linear fashion. Countries, both large and small, should take note of this experience and prepare for disruptive change as pressure continues to build along new fault lines.

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Landfall Strategy Group is a Singapore-based research and advisory firm that provides advice on strategic issues to governments, firms, and financial institutions, particularly in small advanced economies. We provide distinctive perspectives on emerging global trends, working with decision-makers to understand key global changes and how governments, firms, and institutions should respond and position themselves in the emerging global economic and political environment.

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