Box 1. Escalation of protectionist tendencies: context and potential effects

In the aftermath of World War II, Western countries saw the emergence and strengthening of economic openness trends. In Europe, the economic interdependence relationship of former wartime enemies, which eventually resulted in the forming of the European Union core, was promoted also in view of peacekeeping. After the fall of the Iron Curtain, trade openness was a condition for the former socialist countries to achieve market economy status. Accession of a significant number of Central and East European countries to the European Union, after having adopted the *acquis communautaire*, acted as an incentive on their economic openness, facilitating their access even to some extra-EU markets.

At global level, this multilateral trading system developed under the General Agreement on Tariffs and Trade (GATT[1]), the precursor of the World Trade Organization (WTO), ensuring sustainable trade ties over the past decades. Moreover, it opposed the temptations of major importing countries to abuse their market power and impose higher import tariffs. In keeping with the principle of reciprocity, WTO members showed willingness not to exploit a potential dominant position as long as the other members maintained a cooperative behaviour. According to estimates, after eight rounds of talks conducted between 1947 and 1994, average import tariffs stood 85 percent lower (Bagwell and Staiger, 1999; Bagwell *et al*., 2016).

This status quo of multilateralism proved efficient, as maintaining the principles of reciprocity and non-discrimination, the two pillars of WTO, rendered trade agreements impermeable to subsequent renegotiation.

Building on the classical paradigm of David Ricardo's theory of comparative cost and the neoclassical Heckscher-Ohlin model, economists such as Greenspan, Mankiw, Krugman, Rogoff, Wolf or Bhagwati argued that lifting trade barriers would undoubtedly lead to an across-the-board increase in wealth worldwide, an opinion that went mainstream in academic quarters.

Within this theoretical framework, from the viewpoint of advanced economies, capital flow liberalisation would foster higher returns on investments in emerging markets, whereas liberalisation of flows of goods would benefit consumers thanks to lower prices, as local producers would gain access to cheaper labour force following the expansion of cross-border production networks. From the viewpoint of emerging economies, foreign investment flows that would enter the domestic market would lower the financing cost of economic activity, while foreign direct investment would boost employment, push up wages, and help create a better business environment via technology and know-how transfers.

In a nutshell, the losers of globalisation would, in this model, be the workers in advanced economies (via downward pressures on wages) and local investors in the

[1] The original GATT text (GATT 1947) is further in place at the WTO, subject to the 1994 GATT amendments, with Romania gaining membership in 1971.

emerging economies (following upward pressures on labour cost and competition pressures at enterprise level – from corporate governance to technological know-how).

In the case of a two-economy model, the losers of the abolishment of trade barriers are compensated by transfer, so that, after redistribution, every individual benefits from market liberalisation, the ensuing gains outweighing autarky by far. Even though in the short term an advanced economy would experience job cuts, long-term efficiency gains arising from the dynamics of the comparative advantage would help increase the national output in both economies, leading to a more efficient allocation (in the more productive sector) of the newly-freed resources, a process that Schumpeter referred to as "creative destruction".

Others, however, voiced their dissent over unregulated globalisation. A theoretical argument was formulated by Samuelson (2004), showing that a technological innovation of the developing country in the sector that does not have a comparative advantage could lead to a permanent decline in wage rates in the corresponding sector of the advanced economy having a comparative advantage. It is possible for the loss to be so large that the net effect of liberalisation becomes nil or even negative for the latter. The same opinion expressed Rodrik (1997) and Stiglitz (2002), both warning that the magnitude of the losses incurred by some globalisation-affected players in the advanced economies is underestimated.

The prevalence of the opinion that trade liberalisation benefits all participants was, nonetheless, supported by positive economic developments, with sustained global growth rates towards the end of the 20th century and in the following years, coupled with market buoyancy fuelled by loose monetary conditions. This vision was embraced by economic circles, advanced economies' governments and international financial institutions, and the success of some economies in Asia, the establishment of NAFTA in 1994 and the enlargement of the European Union came as a confirmation of the free trade theory. According to IMF estimates, trade openness helped halve the percentage of the population living in absolute poverty at global level, entailing a structural change in the developing economies and creating new employment opportunities. Foreign direct investment played a role in boosting economic growth, created jobs and brought about productivity gains, sent exports higher (including to previously inaccessible markets), and spurred integration into international production chains. These dynamics became axiomatic, Paul Krugman (1999) arguing that every success story of the countries where the standard of living improved considerably in the 20th century "has taken place via globalisation, that is by producing for the world market rather than trying for self-sufficiency".

Specifically, until the outbreak of the financial crisis, the reduction of trade barriers was thought to contribute decisively to global growth and development, while the deregulation of labour market and financial instruments tended to be promoted as well. Given the competitive pressures for a more investor-friendly environment, which led to a lower tax burden on companies and/or to tax exemptions to

bring in investors, the redistribution of gains from trade was often overlooked. Also contributing thereto was the fact that fostering investment and cost competitiveness through such means compressed the fiscal space available to the authorities, the phenomenon being enhanced by companies' tendency of using transfer prices for profit shifting to tax havens.

Under the circumstances, the recession triggered by the financial crisis revealed a weaker intervention capacity of social protection mechanisms in the advanced economies, with individuals' confidence in institutions being further eroded by fiscal policy measures that were aimed at bailing out the financial system rather than providing tangible benefits to individuals. In fact, deindustrialisation in advanced economies exerted an asymmetrical impact, affecting the low-skilled workers often concentrated in certain geographical areas. As an argument for underestimating the globalisation-induced losses, Rodrik (2017) shows a significant decline in real income and an increase in its volatility over the past 40 years for low-skilled workers in the US and the euro area. Actually, the last three decades witnessed a declining share of labour compensation in total gross value added, especially in advanced economies (OECD, 2012; IMF, 2007). These developments were associated in the literature with globalisation as well as technological progress and demographic factors (including not only immigration, but also the ageing of population), all of which tending to divert income distribution in favour of capital. The substitution of capital for labour, amid automation and a slashing of transaction and relocation costs, together with weaker bargaining power of labour following the relative increase in labour supply worldwide and flagging demand for low-skilled workers (Arpaia *et al*., 2009), has had a negative bearing on the perception of the individuals directly affected by such changes.

The financial crisis prompted the surfacing of the dissent that had built up in the advanced economies, and criticism at economic openness and the proposals for protectionist solutions cropped up more frequently in the public discourse. Some advanced economies with significant trade deficits opted for conducting bilateral talks to support certain sectors or to protect labour force segments. These measures are likely to change the dynamics of the multilateral trading system in case of cascading retaliatory steps taken by various parties, thus calling into question the institutional continuity of the WTO.

These episodes translated into increased financial market volatility in March 2018, with uncertainty over a potential escalation of trade tensions leaving its imprint on asset price dynamics. At the same time, although in the course of 2017 global trade picked up at a swifter rate, protectionist measures could undermine the recent favourable path of economic activity at global level. The impact of these decisions could materialise via two main channels, affecting both consumption and investment:

(i) Higher import prices might put pressure on production costs and, hence, reduce households' purchasing power, especially if domestic goods cannot be easily and readily substituted for imported goods. These effects would weigh on consumption and investment, and hence would reduce employment.

(ii) The uncertainty associated with a potential escalation of the trade dispute via reprisals would hurt not only consumer sentiment, prompting households to delay/cut back on expenses, but also investors, who should reconsider their business plans. In an economic environment saddled with uncertainty, investors might downsize their stock portfolios and the volume of financing on offer, while demanding higher compensation for risk.

Over the long term, once with the fall in productivity gains that were facilitated by trade openness (virtuous circle), a shift to a policy prone to protectionism could affect the path of global economic growth. Insofar as trade barriers also affect foreign direct investment flows – which will be less attracted by the economies offering the advantage of low production costs unless they have the guarantee that they may channel their exports towards developed countries in a profitable fashion –, protectionist trends will put a drag on the financing of current account deficits in the emerging economies.

While globalisation produced undeniable beneficial effects worldwide, their impact was unevenly distributed among countries and among segments of population, this inequality lying at the very heart of protectionist movements. In this vein, both public and private institutions should reconsider their position towards the public at large in order for the latter to regain confidence that their interests are taken into account in the decision-making process. Regardless of the form of protectionist tendencies and the manner in which globalisation is reconsidered so as to ensure a fairer distribution of benefits, structural reforms and fiscal measures can help mitigate macroeconomic imbalances, thus also allowing the allocation of resources for solving society issues, mainly caused by yawning disparities. Moreover, human capital development by retraining the vulnerable labour force and reforming the education system should top the authorities' agenda, so that the shock triggered by technological progress be smoothly absorbed by the labour market and innovation-driven welfare become available to the greatest extent possible.

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