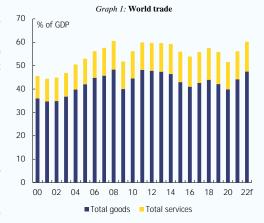
## Box 1.1: Global trade fragmentation risks

Global trade has lost dynamism in the last decade and its growth is not expected to regain traction. While global trade as a share of GDP increased rapidly before the Global Financial Crisis (GFC), from around 41% in 1996 to more than 60% in 2008, it has stalled since then (Graph 1; see also Wozniak and Galar, 2018). Taking into account the more complex and, sometimes, more hostile global environment for trade relations, as well as changing economic drivers, going forward world trade growth is set to be in line or slightly below global output (WTO, 2022; BCG, 2022). In light of these trends, this box reviews the slowdown in global trade and its underlying factors, while suggesting elements that are likely to influence its future performance.



EU goods trade and, particularly, services trade have expanded above global trends since the GFC. Partly as a result of the integration into the world trade system of EU

Member States joining after 2004, the EU goods trade share of GDP increased by 10 pps. between 2000 and 2021, from 57% to 67% ( $^1$ ). The EU's trade share in services increased faster than trade in goods, from 14% of GDP in 2000 to 26% of GDP in 2021. Similarly, the EU's participation in global value chains increased rapidly until 2008 but remained relatively stable afterwards. Foreign value added in EU gross exports, also known as 'backward participation' in value chains, rose from 12.7% in 2000 to 17.3% in 2012, declining moderately to 15.8% in 2018. The EU domestic value added in partner countries' exports ('forward participation') increased from 14.9% in 2000 to 16.5% in 2008, gradually falling back to 14.9% by 2018 ( $^2$ ).

Several economic and policy factors explain the slowdown of global trade during the last decade. First, the benefits from trade-facilitating levers seem to have been largely exhausted. The world's weighted average tariff applied on traded manufactured goods fell from 13.6% in 1986 to 7.5% in 2008 and to a low of 3.9% in 2019. Second, the marginal benefits of technological progress in transportation and communication, which facilitated the geographical dispersion of productive processes, are reaching diminishing returns (Antràs, 2021 (³)). Third, further offshoring is being restrained by a stabilisation of the share of manufacturing in high-income nations and by a decline in the share of intermediate goods in imports for emerging countries, as the latter are increasingly relying on their own industrial base to provide inputs (Baldwin, 2022 (⁴)). Fourth, in some key emerging economies, notably China, an increasing share of services in the economy and a reduced integration in global value chains contribute to the decline in trade openness, ultimately reinforcing the moderation in global trade. Compared to goods trade, services trade retained its dynamism (except for tourism during the COVID shock) as digital technology improvements boosted trade in intermediate services (Baldwin, 2022) (⁵).

Geopolitical tensions and the COVID-19 pandemic have further weighed on cross-border trade and global value chains. Rising antagonism between the US and China in particular have resulted in trade restriction measures and the adoption of industrial policies in technology-intensive sectors (semiconductors, "green technologies", etc.). Shortages in health-related products at the onset of the COVID-19 pandemic raised calls in favour of nearshoring or even nationalising some supply chain segments. The war in Ukraine has further

(Continued on the next page)

<sup>(1)</sup> This increase was driven by both intra and extra-EU trade, as the share of intra-EU trade in goods has remained fairly constant, at around 60% of the total (for goods) for the past two decades.

<sup>(2)</sup> Trade integration data is produced with significant time lag, with the latest data points typically being 2018 and 2019.

<sup>(3)</sup> Antràs, P. (2021). "De-Globalisation? Global Value Chains in the Post-COVID-19 Age". National Bureau of Economic Research Working Paper No. 28115. November.

<sup>(4)</sup> Baldwin, R. (2022). "The peak globalisation myth". VoxEU column available at <a href="https://cepr.org/voxeu/columns/peak-globalisation-myth-part-1">https://cepr.org/voxeu/columns/peak-globalisation-myth-part-1</a>

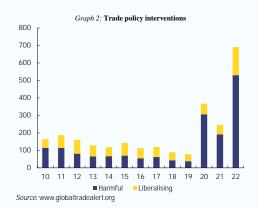
<sup>&</sup>lt;sup>5</sup>) This was particularly the case in high-income countries and regions, such as the EU, which generally have few barriers to this sort of exports.

## Box (continued)

raised geopolitical tensions, bringing to the fore risks that trade could increasingly be driven by geopolitical rather than economic considerations. Overall, efforts to boost the reliability of sourcing, improve responsiveness to demand or prioritise national security concerns are likely to relocate and shorten some supply chains (IMF, 2022 (6); Capital Economics, 2022 (7)).

Trade relations have been influenced by challenges to the rules-based order. Examples are the United States abandoning the Trans-Pacific Partnership in 2017 or the disabling of the World Trade Organisation's dispute settlement system. In this context, the ability of multilateral institutions to facilitate global trade flows has been waning (Dadush 2022 (8)).

Recent developments in trade policy signal a continued difficult environment for cross-border trade and global value chains going forward. Although tariffs have remained at low levels overall, the number of non-tariff trade restrictions has risen significantly since 2020, first in the context of the pandemic and later as a result of Russia's war against Ukraine and the ensuing food and energy crisis. Consequently, the annual average of harmful trade restriction measures, which was 71 between 2010-2019, rose sharply to 530 by 2022 (Graph 2). The number of import restriction measures affected 9.3% of world imports in 2021 (WTO, 2022), increasing further in 2022 due to EU sanctions following Russia's invasion of Ukraine.



Several causal factors, including the abovementioned

geopolitical tensions, the pandemic or the need to address climate change pledges, are leading policy to value chain rearrangements. Several countries are introducing subsidies to foster reshoring in strategic sectors and reduce dependence on foreign technologies and inputs. A prominent example is the semiconductor industry, with the US, the EU, Japan and China having implemented measures and subsidies to build domestic manufacturing capacity. Subsidies are expected to increase considerably (°) and tend to be increasingly linked to local production requirements. The US Inflation Reduction Act is a recent example. Several subsidies are subject to local production and sourcing requirements, distorting the level playing field and likely leading to reshoring some supply chains in the green technology sector. While other economies are considering introducing similar subsidy schemes also with local production criteria, the recently adopted European Green Deal Industrial Plan underscores the importance of an open rules-based trade regime for making trade work for the green transition.

Businesses are likely to adapt their strategies in response to these challenges. A survey conducted by the US-China Business Council in June 2022 found that 87% of respondents (US multinationals in China) declared that US-China tensions are having an impact on their operations and investment decisions, with 26% shifting away from industry segments in China, 29% developing separate US and China-specific value chains and 24% disinvesting in China. A similar survey conducted by the EU Chamber of Commerce in China in April 2022 noted that geopolitical tensions were negatively impacting European investments in China, with 7% of surveyed firms considering disinvesting in China as a result of the war in Ukraine, and 33% declaring that geopolitical tensions were decreasing China's attractiveness as an investment location.

Policy pressure to relocate supply chains may not immediately result in a significant change in standard aggregate trade indicators. Rearranging value chains will take time to materialise due to sizeable costs and technological challenges (IMF, 2022). Nevertheless, policy efforts are likely to alter trade patterns. In Asia, for instance, recent years have seen a notable shift in China's export shares, with shares to the US declining and those to ASEAN countries increasing, and with India emerging as a potential new engine for global value

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<sup>(</sup>e) IMF (2022). "Global Trade and Value Chains During the Pandemic". Occasional paper. World Economic Outlook. April.

<sup>(7)</sup> Capital Economics (2022). "Global Economic Fracturing". October.

<sup>(8)</sup> Dadush, U. (2022). "Deglobalisation and Protectionism". Working Paper 18/2022, Bruegel.

<sup>(°)</sup> For instance, US subsidies in the next decade could double compared to the previous decade. For details, see The Economist (2023). "The destructive new logic that threatens globalisation". 14 January.

## Box (continued)

chain development (Banga, 2022 (10)). Hence, policy changes appear to have rather diverted than destroyed trade so far. These new trade patterns are an initial confirmation of the reconfiguration of supply chains in Asia, in response to the deteriorating trade and geopolitical relationship between the US and China. Similar reconfigurations are expected to take place in other regions. Central and Eastern Europe could increase their participation within European value chains, while certain Latin American countries, notably Mexico, could do same in US value chains (AMRO, 2021 (11)).

Changing trade patterns would not necessarily negatively impact aggregate trade indicators but could deliver significant economic costs. Increasing barriers to international trade, FDI and technology exchange could make resource allocation less efficient, with harmful effects for productivity growth. Rising trade restrictions and/or higher trade policy uncertainty would lead to increased global economic fragmentation. The IMF ( $^{12}$ ) shows that a relatively intense fragmentation of the global economy would lead to permanent global output losses, which could range from 0.2% up to 7% of GDP, depending on the severity of fragmentation. Scenarios that combine trade fragmentation with technological decoupling could lead to output losses between 8% and 12% of GDP in some countries.

Overall, multiple factors cloud the prospects for global trade, posing a downside risk to economic growth. Some of the structural factors inhibiting trade growth over the last decade, such as the reduced scope for major technological breakthroughs in transportation and information technologies, are likely to remain broadly unchanged. In addition, recent exogenous shocks and trade policy developments, both at country and multilateral level, suggest that headwinds against the expansion of global trade are intensifying. In this context, the growth-enhancing effects from trade openness that many EU Member States have registered in the past may become less relevant. All things considered, and in light of the research identifying a causal link between trade and productivity and potential output growth (13), the fragmentation in global trade constitutes a downside risk for the global economy, entailing significant potential economic costs (IMF, 2023).

<sup>(10)</sup> Banga, K. (2022). Opportunities, risks and realities of India's participation in global value chains. Institute of Development Studies. 23 November.

<sup>(11)</sup> AMRO (2021). "Global Value Chains in the Post-Pandemic New Normal". Regional Economic Outlook 2021.

 $<sup>m (^{12})~IMF~(2023)</sup>$ . "Geoeconomic Fragmentation and the Future of Multilateralism". Staff Discussion Notes. No. 2023/001.

<sup>(13)</sup> For further details see Singh, T. (2010). "Does International Trade Cause Economic Growth? A Survey". The World Economy. Volume 33, Issue 11. November 2010.