DEGLOBALIZATION AND ITS FINANCIAL IMPLICATIONS: A THEORETICAL PERSPECTIVE

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Abstract

The slowdown in globalization after the Global Financial Crisis in 2008 and the sovereign debt crisis in the Eurozone, especially after 2015, is due to deep structural transformations in the international economy and finance, increasing trade protectionism, growing regulatory burdens, and geopolitical instability. The report systematizes, from a theoretical point of view, the main driving forces behind the slowdown in globalization, the waves of globalization and deglobalization in the world economy, and the possible financial consequences of deglobalization. The analyzed theoretical aspects of deglobalization point to an intensification of the role of state intervention with negative consequences for the process of financial integration, with a refocusing of financial operations on local capital markets.

Keywords: *financial deglobalization, trade protectionism, capital markets*

Jel classification: *F40, F66, G19*

Introduction

In the context of growing global protectionism, it is necessary to assess theoretically the impact of Deglobalization 3.0 on stock markets (e.g., the KOF index, etc.) due to the redirection of trade flows to domestic markets and regions and the refocusing of investment flows to local securities, a heightened trend toward diversification in local assets due to capital constraints, and an increasing level of risk in the global environment. Among the negative aspects of deglobalization processes are increased structural vulnerabilities, especially in small countries with highly open economies, such as Bulgaria, due to limited access to external sources of financing (such as portfolio investments), limited FDI inflows, underdeveloped capital markets, and high dependence on global value chains.

After the 2008 financial crisis, there has been a slowdown in the pace of globalization due to structural transformations in the international economic system and the trend towards mass trade protectionism, a decline in FDI and a shift of investment towards structurally important sectors related to national security, and screening of incoming FDI. Changes are taking place

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in the economic model of international trade in the course of the economy's transition to digitalization, which implies localized models of production and trade.

In theoretical terms, the periodization of the process of globalization and deglobalization establishes that, on average, each wave of globalization and deglobalization lasts about 20 years, with low-income countries being the main losers from deglobalization processes in the international economy. For the current wave of Deglobalization 3.0, in addition to the 2008 global financial crisis and the ensuing recession and Eurozone debt crisis, exogenous factors include the global COVID-19 pandemic of 2020 and the military conflict in Ukraine of 2022, leading to a refocusing of economic activities (so-called "reshoring" and "friendshoring") on a regional basis, with a subsequent reorganization of global supply chains and new challenges to the process of diffusion of technological innovations and economic growth on a global scale.

In the context of the new technological and economic paradigm, dominated by artificial intelligence with the transition to digitalization of economies and intensifying deglobalization processes, a new model of innovative economic development is emerging, with a dominant role for the entrepreneurial state, due to the negative consequences of the neoliberal model of financialization of economies and the need to guarantee global public goods (such as environmental protection, national security, etc.) due to growing weaknesses in the institutional structure and a retreat from democratic values.

Deglobalization and its dimensions

The research paper introduces a clarification to highlight in theoretical frame the trends towards deglobalization or delayed globalization in the field of international finance, setting as a limitation not to analyze aspects in the field of international trade and international labor migration. For the first time, the concept of deglobalization or delayed globalization was used by Bakas et al. (2016) in connection with the reported slowdown in the pace of international trade in the period after the 2008 Global financial crisis (GFC). Bruelgel (2022) connects deglobalization with a decrease in connectivity between countries in trade in goods, services, capital flows, movement of people and technology transfer.

According to Kandil et al. (2020), among the main driving factors for slowing down the globalization process are: low labor costs; rapid response to changes; promotion of competition between suppliers; facilitation in the process of logistics operations; focus on core company competencies; facilitation of strategic market penetration, etc. Other constraints to globalization can be included here, such as: decline in product and process technological competencies, reduction in long-term levels of competition in R&D, accumulation of significant inventories, problems in logistics and in particular in communications and coordination; increasing transaction costs and boosted costs of fuel and transportation in international trade.

For Stanoevic et al. (2023), the reasons for the decline in international trade, FDI and in global value chains should be sought in structural transformations in the international economic system and this requires an analysis of such indicators as inward and outward FDIs, foreign trade (imports and exports), value added in global chains, an increase in the regulatory burden, especially after the GFC since 2008. According to Evenett (2019), the trend towards mass trade protectionism should also be taken into account as a symptom of slowing globalization of the international economic system.

Often cited reasons for the slowdown in international trade in goods, which went from 24% of world GDP (1960s) to around 60% by 2008, are a decline in economic activity and GDP growth (IMF, 2015), cyclical factors such as falling prices, demand and imports (Boz et al. 2020), protectionist measures such as tariffs, non-tariff barriers, tightening of customs rules in the period 2008-2018, the need for radical reforms in the work of international organizations such as the IMF, the World Bank, the G20 and the WTO. In the course of technological innovation in the world, there is also a decrease in final value added, as an indicator of economic integration in global value chains, and an increase in the share of services in trade. For the period 2008-2018, there was a decline in the share of final value added in exports from 31% to 27% according to OECD, UNCTAD, World Input-Output Database. After 2021, a sharp increase in global imports was reported due to the Covid-19 pandemic according to World Bank research (2020), especially concerning trade in intermediate goods within global value chains, which account for over 50% of global trade (Brooking Papers, 2023).

In particular, FDI flows have reported a faster decline than international trade, and especially after 2011 with the onset of recession in developed countries in the world. Due to the GFC, the growth in FDI was about 8%, with a decline of about 23% in 2017, and another 13% in 2018. Inward FDIs in developed countries fell by around 27% in 2018, with some European countries specifically experiencing negative FDI levels due to the withdrawal of investment funds from the US (so-called “reshoring”). According to UNCTAD (2019), the share of restrictive measures on FDI increased from 10% to 34% in the period 2003-2018 for national security reasons, covering sectors such as energy, telecommunications, electrical components, robotics, artificial intelligence, etc. Among these restrictive measures stands out the screening mechanism for inward FDI, introduced in over 20 countries, whose FDI flows account for over 50% of the total level of FDIs in the world.

Stanoevic et al. (2023) study the impact of the globalization slowdown on China's economy, using an autoregressive distributed lag (ARDL) model for short-term effects and a cointegration test to establish long-term interdependencies for the period 1991-2021 with the dependent variable China's GDP and independent variables: inward FDI/GDP, outward FDI/GDP, imports and exports to GDP, and final value added/exports. The results of the empirical analysis show a high dependence of GDP growth on changes in international trade, investment, and production. Inward FDI has the strongest impact on China's GDP. An increase in this indicator by 1 percentage point in a given year contributes to a growth in China's GDP by 1.03 percentage points in the following year. On the other hand, an increase in outward FDI by 1 percentage point is associated with an increase in GDP by 1.87 percentage points in the following year, and the growth of imports by 1 pp. correlates with an increase in China's GDP by 1.01 pp. In the long term, the empirical results report a strong influence of the variables, but weak statistical significance since the included indicators depend on external environmental conditions. The results point to a new paradigm with a growing role of China as a global investor with the potential for deglobalizing effects on the world economy.

Factors contributing to slowdown in globalization

Among the factors contributing to the slowdown of the globalization process (Bergeijk, 2020) stand out: 1) changes in the economic model in the course of the digitalization process and the introduction of new technologies and robotics, 3D printing, etc., providing cost-effective means for localized production, close to end users; 2) growing concerns about protectionism and anti-globalization sentiment with a potential shift towards state isolationism (growing concerns about job losses, falling real wages, deindustrialization, social inequalities, job displacement, etc. increasingly intense conflicts over trade and financial regulation and increasing hostility towards migration); 3) escalating trade tensions (e.g. between the US and China, which have been in a state of trade war for several years). Trade policy tensions are not limited to the US-China dispute. The US is also threatening high tariffs on EU goods and has ongoing disputes with India and Vietnam; 4) post Covid-19 situation is contributing to nationalist policies and is likely to have long-term negative consequences for globalization with a rethinking of supply chain strategies (shortening or diversifying supply chains to improve reliability of supply) and concerns about food security in some countries; 5) tariffs can be raised to support climate change policies, introducing new regulations to reduce carbon emissions, making geographically dispersed chains even more expensive; 6) reducing greenhouse gas emissions by imposing tariffs and adopting carbon border taxes against countries that withdraw from the Paris Climate Agreement.

As can be seen from the periodization in Table 1 below, the second wave of globalization (the so-called “Globalization 2.0”) from the second half of the 19th century to the World War I, is associated with the advancement of transport technologies and the reduction of tariffs and other restrictions on international trade and the hegemonic status of Britain in international relations. The third wave of globalization (the so-called “Globalization 3.0”) is associated with the period of recovery after World War II with the Marshall Plan, the Bretton Woods Conference and the establishment of the IMF, GATT and later the WTO, and continued until 1980 with the leading country - the hegemonic status of USA. This was followed by the establishment of a plateau in the globalization process after 1981 to 1993, and this period is associated with the consequences of the two oil crises of 1973-1974 and the debt crises in Latin America. Globalization 4.0 continued after 1994 until the beginning of the GFC of 2007-2008 and is associated with increasing trade and financial liberalization after the collapse of the Soviet Union, and the period of economic expansion in the Asian region. For Mokyr (2017), there is a positive correlation between the increase in trade and financial liberalization during this period and the rapid technological progress on global scale. As a sub-period of globalization, hyper-globalization of the 1990s reported a rapid increase in world trade due to a decrease in transaction costs with the introduction of new technologies, China's integration into the WTO, an increase in FDI flows, as well as industrial production.

Table 1: Periodization in globalization and deglobalization

Period	Start	End	Duration (years)
First Wave of Globalization (1.0)	1849	1878	29
Deglobalization 1	1879	1901	22
Second Wave of Globalization (2.0)	1902	1920	18
Deglobalization 2.0	1921	1944	23
Third Wave of Globalization (3.0)	1946	1980	35
Plateau	1981	1993	12
Fourth Wave of Globalization (4.0)	1994	2008	14
Deglobalization 3.0	2009	?	?

Source: adapted from Chase-Dunn, Christopher, Alexis Álvarez, and Yuhao Liao (2023)

According to Bergeijk (2020), the mechanism of slowing down globalization is associated with: 1) Redistributive processes from globalization at the national level, where a layer of the labor force stands out that is in a position of losing from increased globalization, and this necessitates the adoption of protectionist measures, especially in leading economic countries, which signals an initial stage of political deglobalization. According to Stiglitz (2005), the losers from the globalization process are mainly countries with low income per capita, in which trade liberalization leads to a decrease in productivity and an increase in the unemployment rate. A correlation is established between globalization and the growth of income inequality in a global aspect. 2) An external shock in the form of a financial crisis and/or the onset of a global (military) conflict. “Deglobalization 2.0” is associated precisely with the occurrence of the stock market crash in the USA in 1929, the subsequent Great Depression in the 1930s in the course of increasing trade protectionism in the USA, and the customs restrictions and quotas imposed by the Smooth-Hawley Act, as well as the concomitant outbreak of the World War II.

In the study by Bergeijk (2020) in the current phase of “Deglobalization 3.0” the cyclical process of slowing down globalization is associated with the recession caused after the 2008 GFC and with the subsequent collapse in the indicators of world trade and investment. According to a study by Goldman Sachs (2022), the period of “Deglobalization 3.0” is associated with the 2008 GFC and is characterized by a pronounced bifurcation of the world into two main economic blocs around the USA and China, respectively. For the USA, the retreat from globalization processes is additionally associated with protectionist measures after 2016, with the protection of jobs in the USA against global competition from China, and the subsequent trade war between the two leading countries in the period 2018-2019 (NBER, 2023).

The global Covid-19 pandemic of 2020 represents the other significant external shock (on the demand and supply sides) in international economic and political relations after World War II, which led to a refocusing of economic activities within national economies. As a result of the pandemic shock, world GDP contracted by about 3.2. % in 2020, but in 2021 it reported a growth of 5.9 % due to an increase in demand for sanitary and other goods within global value chains. Last but not least, Russia's special military operation in Ukraine in 2022 marked another external shock to international relations and a refocusing of economic and political activities on a regional basis (the so-called “friendshoring”, i.e. a predominant share of trade exchange in a limited circle of friendly countries), with the imposition of a series of restrictive measures and export restrictions by the EU and the US towards Russia and the countries of the Global South (i.e. “decoupling” or breaking off trade and other dependencies from hostile countries).

“Deglobalization 3.0” is characterized by a combination of economic nationalism and geopolitical fragmentation in the context of digital transition, a growing share of the services sector in international trade flows, concerns about environmental protection in the face of climate change, the challenges of the green transition, ensuring national security and the growing role of trade in goods with possible dual use (e.g. semiconductors, artificial intelligence, etc.). This phase of deglobalization is therefore a consequence of various forms of state dirigisme and interventionist policies, which marks the end of “Globalization 4.0” and the transition to a new “cold” war in international relations. For Bairoch (1996), structural globalization consists of a diverse type of interactive networks in the world (economic, political, social, migration, communication, etc.), as a single structure of connectivity (i.e. measured by KOF Globalization Index) and periodically goes through phases of slowing down, reaching a plateau and turning towards deglobalization.

Financial implications associated with the slowdown in globalization

In a study of possible scenarios from deglobalization (Hillebrand, 2010), which included 183 countries, the simulations in the model reached such results as: 1) A decrease in global economic growth by 1 percentage point (pp) per year, with a larger decrease assumed in non-OECD countries (i.e. by about 1.9 pp). The average income per capita for 2035 (at 2000 PPP) for non-OECD countries is expected to be $8,398 and the Gini coefficient to be 0.416. 2) Due to an increase in trade tariffs, a decline in world trade is assumed by about 2 pp per year. 3) Due to restrictions on FDIs and development aid, in non-OECD countries a decrease in GDP per capita growth is expected by about 0.2 pp. 4) Increasing poverty, social inequalities in most of the analyzed countries, probability of political instability and the outbreak of wars between countries. The probability of wars breaking out is highest in countries with autocratic regimes (20.4%), while for OECD member countries it is 0.4%. The growth of China's military power relative to the USA may result in an increase in the probability of war in the next few decades. 5) For the USA, due to a decrease in the inflow of migration by over 30 million people by 2035, a decrease in GDP of about 3% is assumed, while in the EU real GDP per capita is expected to be about 0.8 pp per year less than in the globalization scenario. Due to an increase in the probability of political instability, the largest possible decline in the GDP growth rate is predicated in China.

In the short to medium term, the “Deglobalization 3.0” phase is expected to lead to a reorganization of global supply chains (“reshoring”, “friendshoring”, etc.) with an increasing importance of bilateral/regional trade, economic and political ties. In forecasts by the Brookings Institute (2023), the average costs of severing off trade dependencies (i.e.“decoupling”) of the US from China, given the over 20% imposed trade tariffs in bilateral trade, suggest a loss of GDP for the US of over $190 billion by 2025.

In the long term, the negative consequences are expected to be much greater due to overlapping restrictions not only on trade, but also on financial flows, the growing migration flow in the world under conditions of “massive modularity” (according to Thun et al. 2022). This multifaceted complexity of production systems would create insurmountable obstacles to technological innovation and economic growth in a global perspective, especially for small, low-income countries such as Bulgaria, and would deepen social stratification and inequalities.

One of the financial implications of the slowdown in globalization is associated with increasing vulnerabilities as economies become less open due to a forced retreat from globalism, with negative impacts on the global economy. Important indicators in this respect are the change in the merchandise exports/GDP ratio, as well as the change in the KOF Globalization Index. Small open economies that have experienced large increases in their export/GDP ratios may be most affected. Middle-income countries with generally lower levels of globalization tend to benefit more from increased international economic integration than higher-income countries that are already highly globalized (i.e., with diminishing marginal returns to globalization).

The KOF Globalization Index suggests that emerging market countries have become increasingly integrated into the world economy over the past two decades. The impact of deglobalization depends on a variety of factors, including domestic policy responses and corporate sector behavior (such as the internalization of supply chains and the rebalancing of major economies like China, which are curbing investment and exports and redirecting them toward stimulating domestic consumption, so there will definitely be global losers and winners from deglobalization. It is possible that major advanced economies will refocus on their domestic markets, and this could undermine the development prospects of poorer countries like Africa and others that hope to pursue export-oriented industrialization strategies.

Business cycles are expected to become less synchronized in a more fragmented world with trade flows likely to become more regionally concentrated, supply chains shortened, and levels of cross-border trade and investment reduced. This would negatively affect access to credit, liquidity, and increase instability in some markets and segments. Geopolitical instability is increasing the risks to global supply chains and intensifying competition between countries seeking to diversify their energy sources for production.

Diversification will become an increasingly important strategy as a result of deglobalization. National markets are becoming less vulnerable to external shocks but are exposed to internal vulnerabilities and economic conditions. National stock markets are expected to be characterized by lower returns, higher volatility, greater dispersion of returns on securities; a decrease in correlations with global indices and an increase in institutional investors' preference for local pension fund securities.

Shares listed on national stock markets would yield more reliable returns, and economic sectors with internally generated income streams (such as construction, utilities, etc.) would be more insulated from external shocks, realizing certain benefits from increased domestic investment in national supply chains. Similarly, small-cap stocks are typically less exposed to foreign demand. Export-oriented companies that are heavily dependent on global value chains may suffer the most negative consequences. With the cost of capital rising, companies with higher leverage are also expected to perform less well financially. Firms with greater flexibility in their operations are well positioned to adapt to uncertainty and changes in the environment. Investors are seeking to take advantage of regional differences resulting from protectionist policies.

Last but not least, higher inflation could make fixed-income investments (i.e., bonds) vulnerable. Bond markets would be vulnerable to potential domestic inflationary pressures and lower economic growth. Greater inflationary pressure would exert strong impact on sensitivity of domestic wages to domestic labor market conditions. The inflation outlook will also depend on exchange rate movements and domestic resource constraints, and there will be reduced synchronization of producer price inflation across countries. Potential return of capital controls would restrict local institutions from investing in foreign enterprises, with a significant impact on investor returns and reduced opportunities for portfolio diversification.

Conclusions

Deglobalization processes following the 2008 global financial crisis, the 2020 COVID-19 pandemic, and the 2022 military conflict in Ukraine are associated with a decline in connectivity between countries in international trade in goods, services, capital flows, movement of people, and technology transfer. Among the driving forces behind the slowdown in globalization processes are structural transformations in the international economic system (e.g. foreign trade, declining final value added in global value chains, increasing regulatory requirements and restrictive trade measures, cyclical factors, the growing share of services in international trade) and trends toward mass trade protectionism by leading countries such as the US and China.

Foreign direct investments have declined more rapidly than international trade in goods since 2011 in the wake of the recession following the GFC, the restrictive measures imposed on trade (for reasons of national security in sectors sensitive to countries such as energy, ICT, robotics, AI, etc.) and the beginning of the process of "reshoring" or returning financial flows of large investment funds back to their country of origin. A number of empirical studies (including that of Stanoevic et al., 2022) point to a transition to a new paradigm of international trade with the growing role of China and its potential to generate deglobalizing effects on world trade.

The role of digitalization in the economic model based on the post-industrial knowledge society, which implies localized models of production and trade, should not be underestimated. In addition, the importance of state isolationism, especially on the part of the USA, is taken into account, with a prioritization of the focus on the domestic economic environment, escalating trade tensions globally, and imposition of new regulatory burdens to protect against climate change. In the context of delayed globalization after the “Globalization 4.0” phase (1994-2008), the main losers are expected to be countries with low per capita income, growing social instability, and high unemployment rates.

This stage of “Deglobalization 3.0” is defined as a complex combination of economic national protectionism and geopolitical decoupling from strategic trade and other dependencies on now hostile countries and a refocusing of trade flows on a regional basis ("friendshoring") with a transition to a new "cold" war in international trade, economic, and geopolitical relations.

In the wake of the deepening geopolitical and geo-economic consequences of “Deglobalization 3.0”, linked to restrictions on technological innovation and economic growth, there is a pressing need for state dirigisme and interventionist policies (Mazzucato et al., 2021) to achieve certain domestic economic and social goals related to the UN Sustainable Development Goals and Agenda 2030.

This requires the state to take on the role of an active innovative entrepreneur to correct market imperfections related to the production of global public goods (such as combating climate change, protecting the environment, green and digital transition, protecting national and intra-regional security etc.). In theoretical studies, the provision of this type of goods is threatened by two types of failures: market and state (especially in cases of a "captured" state with blocked institutional capacity, such as Bulgaria), which necessitate active international or intra-regional supranational cooperation for innovative interventions.

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