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Research Report

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Foreign direct investment and “peak globalization”*

by

Carlos A. Primo Braga **

Globalization is characterized by the growing economic interdependence across countries, fostered by international trade, migration, knowledge, and capital flows. Attitudes toward this process vary significantly. More recently, they have been impacted by the global financial crisis and the rise of populist leaderships that blame globalization for job destruction and rising income inequality. Financial globalization has slowed down significantly since 2008. By 2016, global cross-border capital flows had declined roughly 65% vis-à-vis the peak (of US\$12.4 trillion) reached in 2007.¹ Most of this adjustment was associated with the reduction of foreign exposure by Eurozone banks amid the Eurozone crisis.² But FDI flows also fluctuated significantly over the past few years, and they only recovered to levels similar to those reached at the eve of the crisis by 2016.

Merchandise trade had been growing on average 7% per year before the onset of the global financial crisis. Since 2008, however, trade growth has been anemic and in some years below the expansion of world output (e.g., 2.3% at market exchange rates for global GDP versus 1.8% for global trade volume in 2016).³ All of these trends raise the question of whether globalization has reached its peak and is it now retreating. What are the implications for FDI decisions and policies?

There are cyclical factors that help explain the slowdown in trade. Weak aggregate demand and political uncertainty (dragging down business investment that tends to be trade-intensive) are often identified as the main culprits in this context. But there seem to be more structural forces at work. The shortening of supply chains to cope with environmental and geopolitical risks, trade protectionism, increased local content in Chinese exports, and the evolving shift toward services in the world economy are some of the usual suspects identified in this context.

There is evidence that discrimination against foreign commercial interests has increased significantly in the post-crisis era.⁴ Subsidies, localization requirements and trade finance have been playing an important role in this new wave of discriminatory actions that often evade multilateral disciplines. It is difficult to quantify their exact impact on global trade flows, but there is no doubt that they are contributing to the trade slowdown. Moreover, recent

technological developments (as illustrated by the impact of advanced robotics on re-shoring decisions by MNEs) have also impacted globalization trends.

Concerning FDI flows, it seems that efficiency-seeking investments (typically export-oriented) are being affected not only by protectionist policies, but also by the retrenchment of global value chains (as the incentives for process fragmentation decline) and by technology, to the extent that labor costs are becoming less influential in localization decisions.⁵ All these factors are generating incentives for localization in smaller, flexible production facilities closer to end-markets. As a consequence, MNEs are rethinking their localization strategies to adapt to the increased adoption of local content requirement policies and to explore industry 4.0 manufacturing.

It may be too early to announce that we have reached “peak globalization”. One could even argue that we are in a moment of resetting global production structures, and that digital flows associated with e-commerce, social networks and entertainment are today the main drivers of globalization. As the global economy regains strength (as illustrated by the latest IMF forecasts for 2018) and demand for consumer and capital goods recovers, one should also expect a recovery of traditional trade flows. The elasticity of trade with respect to income has already rebounded closer to its historical average (1.5) in 2017.⁶

However, the specter of a less integrated world economy is real.⁷ Recent developments (e.g., Brexit, the adoption of protectionist measures by the Trump administration and reactions from trade partners) underscore the potential for economic disintegration. The volume and composition of FDI flows are bound to be affected by these developments that tend to create incentives for market-seeking investment while feeding doubts about the benefits of export-oriented FDI.

Policy-makers need to resist the temptation to adopt policies that further advance these trends, such as restrictions of FDI flows designed to force technology transfers. More attention should be given also to the rules of the game and the infrastructure required to promote digital globalization. For example, rules on local data storage/processing and cross-border data transfer should be carefully evaluated since they may threaten the business models of digital firms and hamper FDI flows in this new era of globalization.

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¹ Susan Lund, et al., “The new dynamics of financial globalization,” *McKinsey Global Institute Report* (2017).

² Bank for International Settlements, *87th Annual Report* (Basel: BIS, 2017).

³ WTO, “Strong trade growth in 2018 rests on policy choices,” Press/820.

⁴ See, <http://www.globaltradealert.org>.

⁵ See M.P. Timmer et al., “An anatomy of the global trade slowdown based on the WIOD 2016 release,” *GGDC Research Memorandum*, 162 (University of Groningen, 2016).

⁶ WTO, “Strong trade growth in 2018 rests on policy choices,” [Press release 820 \(April 12, 2018\)](#).

⁷ For a detailed discussion, see Carlos A. Primo Braga, “The threat of economic disintegration,” in Carlos A. Primo Braga and Bernard Hoekman, eds., *Future of Global Trade Order* (EUI, IMD and FDC, 2017), pp. 29-47.

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