# The best way to defend globalisation from its enemies

**Global economy** It may be wiser to help with an orderly slowing of global integration – and push back when things look better.

Mohamed El-Erian

Having already been buffeted by two big shocks in the past 10 years, the global economy's highly interconnected wiring is suffering a third because of the COVID-19 pandemic. Globalisation thus faces a three-strikes-and-out situation that could well result in a gradual but rather prolonged delinking of trade and investment, which would add to the secular headwinds already facing the global economy.

Appeals to recommit to the current globalisation process are almost certain to fall on deaf ears – particularly because this latest shock will be driven simultaneously by governments, companies and households in developed countries. Those keen to preserve globalisation in the longer term would instead be better advised to focus on minimising the disruption caused by the coming period of deglobalisation and laying the groundwork for a more sustainable process thereafter.

For starters, it is already clear that many firms will look to strike a more risk-averse balance between efficiency and resilience as they emerge from the damaging pandemic shock. The corporate world's multi-decade romance with cost-effective global supply chains and just-in-time inventory management will give way to a more localised approach involving the reshoring of certain activities.

This inclination will be reinforced by government mandates to secure safer inputs for sectors deemed to be of national-security interest. We are already seeing such requirements in the United States for energy generation, telecommunications, healthcare materials and pharmaceuticals. It is only a matter of time until this trend spreads to other sectors and countries.

The aftermath of the current crisis-management phase is also likely to feature an intensified blame game, adding a geopolitical impetus to deglobalisation. Already, the US is complaining that China didn't do enough to contain the spread of the virus and inform other countries of its severity. Some US politicians have even called for China to pay reparations as a result. And many in America and elsewhere perceive China's initial COVID-19 response as yet another example of the country failing to live up to its international responsibilities.

A Trump rally: Nativism is just one enemy of an interconnected world. PHOTO: BLOOMBERG

Moreover, the worsening geopolitical situation will likely intensify the weaponisation of economic policy tools that accelerated during the China-US trade war – the second recent blow to the globalisation process. That in turn will confirm many multinational companies' fears that they can no longer rely on two key operating assumptions: the ever closer integration and interconnectedness of global production, consumption and investment flows; and the orderly and relatively predictable resolution of trade and investment conflicts through multilateral institutions applying the rule of law.

Today's anti-China rhetoric will also give fresh momentum to the first push-back against globalisation that emerged a decade ago. With some segments of the population feeling alienated and marginalised by the process, the anti-establishment backlash gave rise in some places to more extreme political movements that have scored some surprising successes, not least Brexit. Such developments greatly weakened global policy collaboration, as has been starkly evident in the world's unco-ordinated approach to containing COVID-19.

> *This third strike against globalisation has sent it back to the dugout for now.*

This is not an ideal time for the world economy to undergo secular deglobalisation. Most countries, and virtually all segments of their economies (companies, governments and households), will emerge from the crisis with higher levels of debt. Absent a major round of debt restructuring, developing countries in particular will find their ability to service this debt hampered by high levels of unemployment, lost income, more sluggish economic activity and, perhaps, less dynamic consumption.

Against this background, those who appreciate the power of cross-border interconnectivity to unleash win-win economic opportunities and reduce the risk of major military conflicts will be inclined to defend the pre-pandemic status quo. But this approach is unlikely to gain traction at a time when governments have become more inward looking as they battle the pandemic's direct and indirect damage, companies are still reeling from disruptions to their global supply chains and markets, and households have a heightened sense of economic insecurity.

Rather than fight an unwinnable war of principle, advocates of globalisation should adopt a more pragmatic approach that focuses on two priorities.

First, they should find ways to manage an orderly and gradual process of partial deglobalisation, including avoiding a descent into self-feeding disruptions that result in unnecessary pain and suffering for many. Second, they should start putting in place a firmer foundation to relaunch a more inclusive and sustainable process of globalisation in which the private sector will inevitably play a bigger design and implementation role.

To revert to the baseball analogy, this third strike against globalisation has sent it back to the dugout for now. But, as in baseball, there will be another at-bat. The challenge now is to use the time on the bench to understand the situation better and come back stronger.

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# Slippery slope ahead for RBA's yield management strategy

**Monetary policy** Engineering low rates politicises central banks, encourages public debt, and distorts private credit. This is not the way to a sound economy.

James Dorn

Federal Reserve officials are fond of touting the importance of independence in the conduct of monetary policy. In theory, they want to avoid politicisation and maintain a firm boundary line between monetary and fiscal policy in pursuing their dual mandate of full employment and price stability.

In reality, however, the Fed is an agent of Congress – or more precisely, a fiscal agent – and, in a crisis, is subservient to the Treasury. During World War II, for example, the Fed supported the prices of US securities and pegged interest rates at artificially low levels to finance government deficits. The pegged rate system didn't end until 1953, even though the Treasury-Fed Accord was announced in 1951.

Today, in response to COVID-19, the Fed has once again become a major player in funding massive increases in government deficits. It has promised to more than double the size of its balance sheet by engaging in large-scale asset purchases of Treasuries and mortgage-backed securities.

The Fed also has created off-balance sheet entities – special purpose vehicles – backstopped by the US Treasury with funds appropriated by Congress under the CARES Act (Coronavirus Aid Relief and Economic Security Act).

Congress has provided the Treasury with $US454 billion ($700 billion) to cover potential losses from the Fed's emergency lending programs. That backstop will allow the Fed to lend as much as $US4.54 trillion.

Although the Fed – unlike the Bank of Japan and, more recently, the Reserve Bank of Australia – has not officially pegged interest rates on government debt, there has been talk of establishing "yield curve control". The idea is to have the Fed commit to buy longer-term bonds to support their prices, and thus peg their yields at whatever rate is decided upon, most likely under consultation with the Treasury.

Although the Fed may see this as a way to stimulate the economy, it could also be a way to fund fiscal deficits at an artificially low rate.

According to Sage Belz and David Wessel, of the Brookings Institution, "a major risk associated with yield-curve policies is that they put the central bank's credibility on the line" – that is, if the Fed promises to peg rates, it runs the risk of straying from its inflation target.

In the case of Australia, the central bank has set a 0.25 per cent target for the yield on three-year government bonds, which meshes with the cut in its cash rate target.

The Reserve Bank distinguishes its yield control approach from quantitative easing. Rather than announce a target for the quantity of bonds it plans to buy, it says it will buy an unlimited quantity of government bonds to keep the bond yield at its targeted low rate.

Governor Philip Lowe has also promised that the board "will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2-3 per cent target band".

He expects the cash rate "will remain at its current level for some years". The problem is, central bankers don't have perfect information. Consequently, forward guidance has not worked very well.

The real economy has a mind of its own and central bank forecasts have a poor track record. When central banks peg rates and try to control the yield curve, they may reduce the quantity of bonds they need to purchase in the short run, if the central bank has credibility, but investors will be incentivised to search for yield by moving to longer-term securities.

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This shift increases duration risk – that is, when the economy starts to recover and interest rates rise, holders of longer-term securities will suffer large losses.

By engineering lower rates and promising to keep them low for several years, the central bank encourages politicians to continue to run fiscal deficits.

Pegged rates also distort the allocation of credit by diminishing the role of private markets. Placing legal ceilings on interest rates (i.e. not allowing them to rise above the maximum rate targeted by the authorities) – and thus supporting bond prices – is not a panacea for creating a robust economy.

Most importantly, once rates are pegged at artificially low levels, they can be difficult to exit.

Politicisation of central bank policy will diminish independence and harm credibility. If inflation increases, there is always the danger of wage-price controls and a loss of economic freedom. Future economic growth will suffer.

Those adverse consequences of pegged rates should not be lost sight of in fighting the COVID-19 pandemic.

The pandemic was not the fault of central banks, nor was the political decision to lock down the economy and put millions of people out of work. In such a situation, the Fed and other central banks had to act quickly and decisively to provide liquidity – to prevent financial instability from leading to further deterioration of the real economy.

Yet unconventional monetary policies are meant to be temporary, not permanent. Ensuring long-run economic growth necessary to restore economic well-being will require adapting to new realities via markets, not manipulating interest rates to finance government deficits and providing cheap credit to favoured groups.

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