Navigating the risks of geo-economic fragmentation - remarks by Vasileios Madouros, Deputy Governor, Monetary and Financial Stability

01 September 2023 **Speech**

Remarks delivered at the Kennedy Summer School [1]

Thank you very much for inviting me to take part in this year's Kennedy Summer School. It is a real pleasure to join you here today.

I spent the day in the South East yesterday and – as part of meeting local businesses – I had the opportunity to visit Rosslare port.

The port has been central to a key transition in recent years: the re-adjustment in the trading relationship between the EU and the UK as a result of Brexit.

Among others, this has upended trade routes to and from Ireland. As companies have sought to reduce reliance on the UK landbridge, the port has been almost a five-fold increase in direct trade of goods with the rest of the EU **(Chart 1)**.

The changing trading relationship between the UK and the EU has been particularly relevant for Ireland, given the historical linkages between our economy and the UK.

But Brexit is one manifestation of a broader structural risk facing the global economy. The IMF has called this geo-economic fragmentation.[2]

Put simply, this refers to the risk of a reversal of the greater integration we've seen globally over decades: in terms of the flow of goods, services, capital, talent or ideas.

Ireland's economic model has embraced – and is dependent on – globalisation.

So, today, I'd like to focus on the potential implications of these developments for Ireland and for domestic economic policy.

The ebbs and flows of globalisation

But let me start with the global context.

The flow of goods, services, capital, talent and ideas across borders has been one of the key structural transformations of the global economy.
This increased integration of the world economy has acted as a catalyst for income growth globally, higher standards of living in aggregate and a large reduction in global poverty.

The world is now highly inter-connected across different dimensions:

- In terms of goods, with global value chains having become a dominant paradigm of production globally. Around half of global goods exports now relate to intermediate goods.
- In terms of capital, with increasing financial integration at a global level. The value of cross-border financial assets internationally is now around two times world GDP.
- In terms of ideas, with technology having enabled a leap forward in the flow of information. In 1990, around 0.4% of the world's population had access to the internet. Today, there are around 6½ billion smartphones globally, enabling access to ideas on peoples' fingertips.

Still, looking over the past 200 years or so, it is clear that the trend towards globalisation has not been a linear one. There have been ebbs and flows **(Chart 2**).

After the first wave of globalisation in the 1800s and the early 1900s, protectionism gained ground during the 1930s, with sharp increases in tariffs globally and the world breaking into trading blocks.

The trend towards increased global integration resumed in the post-war period and accelerated in the 1980s. But this second wave of globalisation was interrupted by the global financial crisis.

The period since then has been characterised by a slowdown in the pace of growth of global trade and capital flows. Some have called this most recent period 'slowbalisation'.

Where we find ourselves now is an environment where the risk of global fragmentation has increased. This has been due to a combination of factors.

- First, growing concerns around the distributional effects of globalisation, in part due to the rapid shift in manufacturing activity away from advanced economies. Since the mid-2010s, these concerns translated into waning political support for further trade integration in some economies, as evident, for example, in rising trade tensions between the US and China.
- Second, the COVID-19 pandemic, which led to a severe disruption of global supply chains. This led to questions around the resilience of complex supply chains when unexpected shocks hit.
- Third, Russia's unjustified invasion of Ukraine and its people, which deepened cracks in the global economic order. It also exposed Europe's reliance on energy supply from Russia, raising broader questions around the national security risks associated with geopolitical dependence for critical goods.

Now, there are growing signs pointing to the potential risk of fragmentation. For example, there has been a sharp increase in the number of trade and FDI restrictions since 2018. FDI flows appear to be increasingly concentrated among geopolitically aligned countries, particularly in strategic sectors.[3]

And mentions of "reshoring", "near-shoring" or "friend-shoring" have become increasingly frequent, both in public discourse and in companies' own reporting.[4]

So far, these developments have not resulted in observed drops in different measures of the level of global integration. But they are certainly already influencing the shape of that integration.[5]

And the long course of history tells that we cannot ignore the risk of fragmentation.

Ireland's journey towards global integration

Let me now turn to Ireland's journey towards global integration.

Our economy has transformed over the past half century – and that transformation has been grounded on embracing globalisation.

As you know very well, this was not always the case.

Until the mid-1950s, Ireland had not set its sails to take advantage of the post-war tailwinds from increased global trade and integration.

Instead, Ireland had retained a high level of tariff protection from the interwar period.

In the 1950s, Ireland explicitly changed economic course to open up the economy to the outside world, through encouraging foreign direct investment and reducing trade barriers.

This change in direction was cemented by membership of the EEC fifty years ago.

Ireland was now part of what eventually became the largest integrated single market in the world.

The depth of integration of the Irish economy with the wider EU economy means that our economic interests are now inextricably linked with those of our EU neighbours.

But Ireland is also unique in its linkages with the US.

Indeed, amongst the EU, Ireland stands out as a particularly favoured location for foreign direct investment by US companies.[6]

By 2020, US companies accounted for around 35% of total employment in foreign-owned firms in Ireland. **(Chart 3)**

Ireland has also bucked the global trend of 'slowbilisation' since the global financial crisis.

Indeed, the continued growth of the multinational enterprises (MNE) sector was a key factor in both Ireland's recovery from the financial crisis and the resilience of the Irish economy during the pandemic.

To some extent, this reflects the specific sectors in which Ireland has specialised.

Inward investment has focused on high-tech industries, including technology and life sciences, two sectors that have had strong, medium-term growth.

Overall, whatever way one looks at it, the highly globalised nature of the Irish economy really stands out:

- MNEs accounted for 87% of corporation tax receipts in 2022, while employees of MNEs accounted for 33% of total income tax in 2021.
- Foreign-controlled companies accounted for over 70% of value added in the (non-financial) business economy in Ireland in 2020, the highest among the EU.
- The share of employment by foreign-controlled companies in total employment is the fourth highest in the EU.
- Ireland is an important exporter of financial services, hosting an increasingly internationally-oriented financial sector **(Chart 4)**.

This global integration has been a source of strength for the Irish economy, but it also entails vulnerabilities, especially in an environment of increased risks of fragmentation.

Economic effects of fragmentation

So what are some of the possible economic effects of geo-economic fragmentation?

A starting point is to recognise that there is much uncertainty around this.

Empirical work on the effects of fragmentation remains limited, not least because these are not effects that we have seen in the data yet.

And, of course, there are many different scenarios that could play out, and the precise effects will depend on the specific form – and, crucially, depth – of fragmentation.

So we are navigating a world of heightened uncertainty.

But we can draw some insights from economic theory.

Let me start with a *global perspective* again.

Geo-economic fragmentation will entail costs for the global economy.

There have been a number of studies that seek to estimate the impact of fragmentation, considering different scenarios.

The estimates vary, but they can be significant, reaching 8-12% of GDP in the long term in some scenarios.[7]

The size of the impact critically depends on the extent to which these policies reduce productivity, including through reduced knowledge transfer or reduced competition facing domestic companies.

Of course, in addition to the steady-state costs, there are also transitional costs, as it takes time and effort to reconfigure supply chains.

And any such changes would also imply increased policy uncertainty, which – as we have seen in the past – can also dampen economic activity and investment.[8]

Fragmentation could also affect prices and inflation dynamics.

In the decades before the pandemic, global economic integration in its various dimensions acted as a positive and persistent supply shock.

The rise in global production capacity through the integration of many emerging market economies into global value chains weighed on inflation.

Reduced trade integration could impact inflation in the opposite direction.

This could happen directly, through lower shares of imports from lower-wage countries. And it could also happen indirectly, through higher costs for multinationals participating in global value chains.

Geo-economic fragmentation could also increase the volatility of inflation, if it resulted in abrupt shifts in trade patterns that led to imbalances between supply and demand.

What are the potential implications of global fragmentation for the Irish economy?

As a general principle, given the small, open nature of the Irish economy, such global shocks would be expected to have an amplified effect on Ireland.

As always in economics, though, it depends.

So let me illustrate the potential effects with an example, focusing on the semiconductor industry, which has been at the heart of the policy debate around de-globalisation.

In a more benign scenario, Ireland could be a beneficiary of 'friend-shoring' policies in some respects, reflecting our strong links with both Europe and the US.

For example, imagine if 'friend-shoring' resulted in some of the production of state-of-the-art semiconductor designs that might have otherwise taken place in Asia shifting to Ireland.

This would further boost domestic technological knowledge, potentially making Ireland a more attractive location for future investment in this industry.

Even in such a benign scenario, however, there would – of course – be costs.

The new chip production would take time to come on stream, potentially leading to higher prices during the transition.

Given the Irish economy is operating close to capacity, new production could further exacerbate capacity constraints in the labour and housing markets.

This could increase costs in Ireland, reducing our external competitiveness.

Finally, any relocation of production to Ireland could also lead to a retaliation on Irish products from disaffecting countries.

There are also more adverse scenarios of potential increased fragmentation.

For example, foreign companies currently based in Ireland may seek to limit the extent of *new* investment taking place here.

This could be either due to a desire to reallocate production to their home markets, or due to increased competition globally for manufacturing of critical products.

Indeed, recently, we have seen increased use of government subsidies to attract investment in strategic assets, such as semiconductors, to reduce geopolitical dependence.

In that context, smaller countries – such as Ireland – may find it more difficult to attract new investment than larger economies with greater fiscal capacity.

Finally, in a tail scenario, foreign companies already operating here could seek to re-shore some of the production that currently takes place in Ireland.

Given the importance of foreign MNEs in Ireland, this would have a significantly adverse impact on Irish output and employment, with an associated risk of loss of high value-added jobs.

It would also have an adverse effect on the public finances, not least given the particular reliance of corporate tax receipts on foreign MNEs operating here.

Overall, depending on the precise nature and depth of fragmentation, it could have large economic ramifications for the global and Irish economies in the years and decades ahead.

Policies to build resilience in a small open economy

Of course, many of the forces that are shaping these trends are global in nature.

So what are the implications of this shifting external landscape for domestic economic policy?

Let me cover three areas.

The first is around the importance of *policies that safeguard macro-economic resilience*.

A stable macro-economic environment is a key precondition for sustained prosperity of people.

It is also a key precondition for remaining an attractive destination for foreign investment, including in a world of heightened uncertainty.

As a small, highly-interconnected economy, Ireland faces greater downside macro-financial risks compared to larger, more diversified economies.

Being part of a monetary union also means that monetary policy is not a lever that can be used to respond to domestic shocks, with monetary policy set for the euro area as a whole.

Our domestic macro-economic management framework needs to recognise these characteristics and be set accordingly.

Fiscal policy needs to guard against pro-cyclical dynamics and avoid the risk of overheating in good times, which can damage competitiveness.

The experience of the 1980s and the early 2000s provide salutatory lessons of the costs of pro-cyclical fiscal policy for a small open economy.

Equally, the fiscal response to the pandemic and the energy crisis triggered by Russia's war in Ukraine demonstrate the value of ensuring fiscal policy has the capacity to operate counter-cyclically.

In the current environment, with the economy operating at capacity and inflation remaining elevated, it is important that the fiscal policy stance does not add further stimulus to the economy.

In addition, the public finances need to be resilient to any shocks to windfall tax revenues from MNE activity in Ireland, which are highly concentrated in a very small number of companies and sectors.

It is, therefore, welcome that the government is considering channelling windfall corporation tax receipts into a longer-term savings vehicle.

The domestic policy framework also needs to guard against risks stemming from financial imbalances, and the potential that vulnerabilities build in lenders' and borrowers' balance sheets.

Again, our own history offers important lessons of the severe consequences of financial imbalances and insufficient resilience of lenders and borrowers.

In the run-up to the financial crisis, there was no policy lever to build resilience against such macro-financial imbalances. Macroprudential policy has filled that gap.

Learning the lessons from the crisis, Ireland has been very active in deploying macroprudential tools to safeguard resilience.

The Central Bank's strategy for deploying macroprudential capital buffers, for example, reflects the higher exposure of the Irish economy to the global environment, including to the risk of structural shifts in international trading arrangements.[9]

The second is around structural economic policies to maintain competitiveness.

Ireland already has a number of characteristics that make it a competitive economy.

It is part of the single market; English-speaking; has a competitive corporate tax regime; a common law system; and high levels of educational attainment.

One area where Ireland often lags behind other countries in cross-country measures of competitiveness is around infrastructure.

High-quality infrastructure is a key ingredient for ensuring a country has the capacity to achieve long-term, sustainable growth and plays a key role in determining quality of life.

It is a critical element of ensuring that the gains of global integration are shared across the population.

And it can also enhance the attractiveness of a place to live, a key factor in terms of retaining and attracting internationally-mobile workers.

Government policies to support infrastructure development – including in housing, the transition to net zero, digitisation and transport – are therefore key to maintaining competitiveness.

This also relates to the composition of government spending and ensuring an appropriate balance between current and capital spending.

Prioritising capital expenditure – within the context of the government's spending rule – will be key to addressing infrastructure needs.

Another important dimension in maintaining competitiveness relates to human capital and skills.

Looking back, the rise in educational attainment following Ireland's education reforms in the 1960s were key in raising living standards, including through higher productivity.[10]

Education also played a part in ensuring that Ireland was an attractive destination for inward foreign direct investment.[11]

The skills our economy needs are likely to continue to evolve amid the rapid technological changes taking place globally, underlining the importance of continuing to nurture human capital for the future.

The third is around playing an active role towards strengthening European integration.

Some of the world's most complex problems will be very difficult, if not impossible, to address absent multilateral co-ordination.

Tackling climate change, preparing for future global pandemics or safeguarding global financial stability are key examples of challenges that can only be met with cross-border cooperation.

Of course, we cannot be blind to the evolving reality of an increasingly multi-polar world.

That underpins the importance of strengthening integration *within* Europe, to be better able to meet future global challenges.

From an economic perspective, completing the banking union and making concrete progress towards a true capital markets union remain essential to strengthen the euro area's shock-absorption capacity and to support growth.

Meaningful progress in these areas would also help to reduce fiscal tail risks in Europe.

Still, as the ECB's Governing Council has noted, the need for a permanent central fiscal capacity remains.[12]

The response to the pandemic, including the creation of the Next Generation EU fund, was a key moment for Europe, demonstrating the benefits of a central fiscal capacity when large adverse shocks hit.

A permanent central fiscal capacity, if appropriately designed, could play a key role in enhancing macroeconomic stabilisation and convergence in the euro area in the longer run.

Conclusion

Let me conclude.

Signs of fragmentation at a global level have been growing.

It is not yet clear whether this will be confined to a change in the *shape* of global integration or the *level* of integration. But the implications of these developments for the global economy could be significant.

Ireland is particularly exposed to the risk of global fragmentation, given the highly globalised nature of our economy.

Of course, these are global forces, largely beyond the control of policymakers in these shores.

But Ireland can navigate the choppy waters that increased geo-economic fragmentation would bring through careful macro-economic management; structural economic policies to maintain competitiveness; and by playing an active role in further strengthening European integration.

Thank you very much for your attention.

Charts referenced above will be available to view later today.

[1] I am grateful to Daragh Clancy, Thomas Conefrey, Mark Cassidy, Sharon Donnery, Patrick Haran, Robert Kelly, Gabriel Makhlouf and Caroline Mehigan for their suggestions and advice in preparing these remarks.

[2] See, for example, 'Aiyar et al (2023) 'Geoeconomic Fragmentation and the Future of Multilatelarism', IMF Staff Discussion Note, 2023/1.

[3] IMF (2023) 'Geoeconomic fragmentation and foreign direct investment', World Economic Outlook, April 2023, Chapter 4.

[4] Goldberg and Reed (2023) 'Is the global economy de-globalising? And if so, why? And what is next?' NBER Working Paper 31555.

[5] See, for example, Alfaro and Chor (2023) 'Global Supply Chains: The Looming "Great Reallocation"', Paper prepared for the Jackson Hole Symposium, 24-26 Aug 2023.

[6] See Fitzerland and Honohan (2023) 'Europe and the Transformation of the Irish Economy", in Elements in Economics of European Integration.

[7] See, for example, 'Aiyar et al (2023) 'Geoeconomic Fragmentation and the Future of Multilatelarism', IMF Staff Discussion Note, 2023/1; Clancy, Valenta and Smith (2023), 'The macroeconomic effects of global supply chain reorientation', Central Bank of Ireland Research Technical Paper.

[8] See, for example, Baker, Bloom and Davis (2016) 'Measuring Economic Policy Uncertainty', The Quarterly Journal of Economics, Volume 131, Issue 4, and Rice (2020) 'Economic Policy Uncertainty in Small Open Economies, a Case Study of Ireland', Central Bank of Ireland Research Technical Paper.

[9] Central Bank of Ireland (2022) 'The Central Bank's framework for macroprudential capital'.

[10] FitzGerald (2012) 'To Convergence and Beyond? Human Capital, Economic Adjustment and a Return to Growth', ESRI Working Paper 419.

[11] Siedschlag, Zhang and Smith (2009), 'What Determines the Location Choice of Multinational Firms in the Information and Communication Technologies Sector?', ESRI Working Paper 336.

[12] See ECB (2023) 'Opinion of the European Central Bank on a proposal for economic governance reform in the Union'.

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