

Ditchley conference report: Macroeconomics in a time of pandemic and war

Ditchley Park, Oxfordshire
18-19 November 2022



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The Delegation of the European Union to the United Kingdom



In November, the CER held its annual economics conference on the macroeconomic consequences of the pandemic and Putin's invasion of Ukraine. The conference brings together leading politicians, officials, academics, journalists and think-tankers working on economic policy issues. The participants in the 2022 conference are listed at the back of this report.

Summary

★ The conference agreed that Europe was inevitably poorer as a result of its response to Russia's invasion of Ukraine: the reduction in gas imports from Russia meant that energy prices in Europe would be higher in the short to medium term than they would otherwise have been.

★ Central banking is exceptionally difficult at the moment. Inflation has been more persistent than dovish commentators expected, and remains far above target. Its second-round effects, with wages rising to compensate for the cost of living, mean the ECB will continue to overshoot its target in 2023. Some discussants at Ditchley argued that made it inevitable that central bankers would continue to raise interest rates and start quantitative tightening. Others argued that, with European economies on the brink of recession, and given the fact that changes in monetary policy take time to have an effect, there was a risk that central banks would raise unemployment too far if they did not stop tightening.

★ Governments are right to smooth out the shock of higher energy prices by subsidising energy in the short term, in order to allow households and businesses to adjust and prevent poverty. However, participants disagreed about the extent to which governments should do this: if price interventions were poorly designed, they would encourage households and businesses to use energy, which was in short supply. Governments should invest more in energy efficiency, because that was the best way to get spending on energy down without reducing output.

★ Countries may see government borrowing costs rise sharply, as in the UK, especially with monetary policy tightening quickly. This calls for raising taxes – or at least having a clear plan to do so.

★ Will labour be scarcer once the effects of the pandemic have waned? Population ageing in Europe and China means the growth of the labour force in these places will soon go into reverse, putting upward pressure on inflation and interest rates. However, poor working conditions for less skilled workers mean that the UK and US, and other countries committed to *laissez-faire* policies, have to strengthen labour market regulation, and that the effects on employment might be more muted than free-market economists think.

★ The European economy has adjusted to energy scarcity better than many expected in the summer of 2022. Gas consumption is down, with industry rapidly switching to alternative fuel sources. The EU is doing enough to prevent supply stoppages this winter and next – liquefied natural gas (LNG), renewables and coal are coming online, and together with reduced energy consumption, that means Europe can do without Russian gas entirely.

★ The US and Europe are right to be concerned about trade dependencies on autocracies – the energy crisis is testament to that. China and Russia have the power to stop strategically important exports to the West and damage their economies. But participants disagreed on the extent to which the US and Europe should deglobalise supply chains, in order to reduce that power. It was important to assess carefully which goods were a problem – perhaps microchips, energy, rare earths and batteries required government intervention, because they were inputs into many other goods. The case for other goods was weaker.

Session 1: How should monetary policy respond to shocks to supply?

With very high headline inflation, and core inflation above target, the European Central Bank (ECB) is tightening monetary policy rapidly. The Federal Reserve and the Bank of England have been faster to raise interest rates, in part because there has been more rapid core inflation in the US and the UK. The ECB must strike a delicate balance between anchoring expectations by tightening policy in the face of a negative consumption shock and guarding against financial instability, especially in highly indebted member-states. Italy's borrowing costs have not spiralled out of control, in part thanks to the ECB's Transmission Protection Instrument, but spreads have been increasing. The risks of policy mistakes are high: the eurozone may be entering a prolonged period of high inflation, potentially in combination with low growth, but it is also possible that the currency union will return to low inflation and low interest rates once the energy and supply shocks subside.

Are we entering a new world of higher inflation and interest rates, or should we expect a return to the macroeconomics of the 2010s? What are the reasons for the differences in core inflation between continental Europe and the UK and the US, and should their monetary policies differ? How should central banks prevent quantitative tightening from leading to financial instability? Will the ECB be ultimately forced to choose between curbing inflation and compressing spreads, and is the Transmission Protection instrument a recipe for moral hazard?

While inflation has surged across the United States, the United Kingdom and the euro area, the underlying dynamics differ across the jurisdictions. There have been shared problems, including disruptions in supply chains and a rapid shift in demand from goods to services as pandemic restrictions loosened, with supply struggling to catch up. In combination with expansionary fiscal and monetary policies, the US has experienced a cyclical overheating of the American economy. As a result, labour markets in the US have become extremely tight, leading to increases in wages, a dynamic also observed in the UK, albeit to a lesser degree. The picture in the euro area looks different, as it is much more exposed to the Russian war in Ukraine. Because the euro area is a net energy importer, surging energy prices have subjected it to a 'terms of trade' shock, in which import prices have risen far more than export prices, making Europeans poorer. There is also more slack in the eurozone economy than America's, with the economy still beneath pre-pandemic trend, and wage growth slower than in the US. With inflation far outstripping wage growth, real purchasing power has been declining. One of the panellists pointed out that the UK has the worst of both worlds: a terms of trade shock coupled with cyclical overheating.

There were different views on the right course of action for central banks. Central banks might fail to keep inflation expectations stable as workers try to compensate for income losses in the form of demands for higher wages. While the Federal Reserve can put the brakes on an economy that is coming out of a position of strength, the trade-offs for the ECB are much starker. For the eurozone, the key question is whether the pandemic and war-induced supply shocks will persist and trigger a dynamic of self-sustaining inflation. In response, the ECB could pursue a policy of 'cautious hawkishness' in the form of increasing interest rates whilst playing a smart communication game to encourage wage and price moderation. But in doing so, the ECB might inadvertently kill off demand, which has been much less strong than in the US, condemning the eurozone to a bad economic equilibrium with unnecessarily high unemployment.

In this environment, the risk of one of the major central banks making a policy mistake is high. Their rapid tightening will only work its way through the economy with a significant lag, by which time supply chains may have normalised and a wage-price spiral may not have materialised. But for the same reason, there is also a risk that central banks will do too little. Some participants pointed out

that inflation might be sticky, as it works its way through relatively rigid markets and wage-setting mechanisms that take time to adjust. Such rigidities are more prevalent in Europe than in the US and the UK. The rapid roll-out of sizeable fiscal measures to shield firms and household incomes from soaring energy bills adds further uncertainty. It can either help to contain inflation by lowering inflation expectations and moderating wage demands, or add fuel to the fire by further stimulating demand, especially where ill-designed policies subsidise energy consumption instead of encouraging energy savings.

Monetary tightening will bring risks of its own that need to be managed. One area of concern is financial stability: this was evident in the UK when former prime minister Liz Truss' budget triggered a bond market sell-off and destabilised UK pension funds. The market for US treasury bonds, a key pillar of the global financial system, has also suffered from bouts of illiquidity. Another risk specific to the eurozone is the stability of public finances as government borrowing costs increase. In this vein, one panellist pointed to the end of the pre-pandemic era in which the ECB's policy was obvious: a loose monetary stance was needed when there was low inflation, an economy with room to grow and the need to stabilise the monetary union.

Some fretted that these dynamics might give rise to a situation of financial or fiscal dominance, in which central banks saw themselves forced to pursue a looser stance to avoid instability in the financial sector or bond markets. However, other participants pointed out that central banks have faced such challenges before and can develop targeted interventions that may not detract from inflation-fighting. For its part, the ECB has learnt from the crises of 2010, 2012 and 2015 that any instability in highly indebted countries can spread quickly. That is why the ECB recently established the Transmission Protection Instrument, which will allow it to buy Italian debt, or that of other countries, while tightening monetary policy more broadly. The announcement of the tool has so far sufficed to calm European bond markets. Whether

the instrument will ultimately have to be used depends on the path of fiscal policy, especially in Italy. Despite its rhetoric, the new government in Rome has so far pursued a very conservative fiscal policy and has shown no sign of changing that prudent course.

The most important drawback of swift rate hikes and shrinking central bank balance sheets is that these measures may choke off the investment urgently needed for the energy transition. Renewable energy investment, so vital to bring down energy prices, is extremely sensitive to higher interest rates because it entails a high upfront capital cost followed by a long, drawn-out, period of pay-offs in the form of cheap energy. For that reason, central banks should consider new tools. The ECB, for example, could introduce a set of its targeted low-cost refinancing operations for green lending by banks.

There were different views about what inflation might look like once the dust settled from the economic shocks triggered by the pandemic and the war on Ukraine. The factors underpinning the pre-pandemic secular stagnation, such as the global savings glut, might reassert themselves. Some participants did not see any inherent reason to believe that these secular forces had been reversed by the pandemic. A return to a low inflation, low interest rate economy was therefore a real possibility. Others at the table, however, outlined factors that made such an outcome unlikely. If deglobalisation materialised it would lead to less efficient markets and drive up prices.

With China's working population peaking, disinflationary demographics might also be at an inflection point. Most future growth in the working age population will take place in Africa, which, however, is much less integrated into the global economy and will therefore not have the same disinflationary effect. The green transition may elevate inflation for a prolonged period, as it will create unavoidable economic and sectoral disruption and requires persistently higher investment and thus demand for scarce resources and inputs.

Session 2: Is more government activism the answer?

During the pandemic, European governments did not provide as much stimulus as the US, and the difference between core and headline inflation in the eurozone has been lower. However, both sides of the Atlantic protected household incomes during lockdowns, and experienced only short-lived rises in unemployment. Now many European governments are seeking to help households cope with higher inflation, through cash transfers and caps on energy prices. Meanwhile, state investment in energy infrastructure and defence must rise substantially to respond to climate change and Russian aggression, and spending on healthcare and pensions will be hard to contain. Countries with high debt ratios may find these pressures strengthen populism (if they try to solve them through higher taxes) or increase yields (if they borrow more). Does the 2020-22 period herald a pivot towards a more activist state, with more redistribution, public investment and interventions in labour markets? Should governments do more to protect incomes during future recessions, as they did during the pandemic? How should governments fund the pressures for spending – through cuts to other spending lines, higher taxation or more borrowing? Is there a need for a permanent fiscal capacity at the EU level, and should it be focused on investment, or on more countercyclical forms of spending?

A big short-term priority for governments is to ease the adjustment that the energy crisis necessitates. In the long term, a range of pressures on public budgets will arise: demands for higher health and pension spending, and public investment for the net zero transition.

Conference participants broadly agreed that economics textbooks were right about how to deal with the energy crisis. The price of imported energy had risen enormously thanks to Putin's invasion of Ukraine. Because European countries were largely net energy importers, Europe was inevitably poorer. The role of government was to distribute the costs of higher energy prices fairly and cut consumption of imported energy.

There were disagreements on the role of fiscal policy, however. One view was that fiscal policy should tighten as interest rates rose, as monetary policy had done; but fiscal and monetary policy were pulling in opposite directions. That meant that central banks had to push up interest rates further. Poorly designed price controls encouraged people to consume energy; it would be better to target support on poorer households, preferably in the form of cash transfers rather than price interventions. Another view was that there were good reasons to smooth out the energy price shock that households and businesses faced. Loose fiscal policy and energy price controls would prevent household consumption from cratering and give people time to invest in energy efficiency.

Economic crises are happening more often. Both the Covid and energy crises prompted governments to conduct emergency spending to prop up household incomes, first, through furlough schemes, and then through energy price controls. Future crises will require more efficient and targeted ways to get money to the right people. Governments need better IT systems so they can deliver support where it is needed. Older people, those in poorly-insulated homes, and car-drivers in rural locations have been worst hit by energy price rises, for example, but the urgent need to provide help means that price controls have been provided across the board.

There is a risk that debt continues to ratchet up with each crisis, so fiscal policy needs to be more counter-cyclical, tightening in periods of growth. Yet one participant pointed out that governments' responses to Covid and the energy crisis had been innovative in that they had sought to preserve the supply side of the economy. Furlough schemes kept workers attached to firms, preventing the scars that unemployment would have caused once the crisis passed. Energy price controls meant that most energy producers did not collapse – skyrocketing wholesale prices and longer-term consumer price contracts were a recipe for financial stress – but meant that energy supply and consumption did not adjust quickly.

In the longer term, the fiscal problem is that governments are not investing enough, while

spending pressures on health, pensions and social care mount. There are huge investment needs, and the real cost of borrowing remains low for governments: interest rates have risen but so has inflation, which means that governments still have plenty of fiscal space to finance the transition. The problem is that they are not doing enough, in part because politicians are myopic, with the political fruits of higher public investment going to future governments. There are always pressures to spend more on public sector wages, while the reform of health and social care services, and pensions, is difficult. All governments are struggling with rapidly rising prices of health care, and citizens in all countries demand more health care provision as societies get richer and older. That means taxes will have to rise.

Broadly speaking, academic participants stressed that governments should improve the efficiency of taxation as they raised the tax take. That meant higher wealth taxation, both of capital and housing, because ever higher tax on labour income would damage incentives to work. It also meant higher taxes on pollution and traffic congestion. Officials, on the other hand, pointed out that history told us that the only way to generate significant additional revenue was to raise tax rates on labour and corporate income, and on expenditure. Inheritance taxes were deeply unpopular in all countries. Perhaps, as societies age, younger workers would become more organised in demanding that older, wealthier people contributed more. The OECD's recent agreement on international tax avoidance suggested that tax politics is changing.

What about raising growth rates? One participant stressed the rise of the intangible economy, with physical assets falling in importance compared to less tangible things like knowledge, relationships between investors, workers and companies, and software and databases.

Investment in the intangible economy is harder than in physical capital, because it is difficult to offer an intangible investment as a security for borrowing. A car plant can be sold off, while the value of knowledge is harder to assess. Raising growth in the knowledge economy means stable and well-designed regulations, taxes and competition policies. Restrictive urban planning is a particular problem, because it keeps clusters of businesses – and cities – small, making the sharing of knowledge harder.

The European Commission's proposals for new fiscal rules would decentralise power, according to one discussant. Next Generation EU (NGEU, the post-Covid investment fund), and fiscal rules reform entailed some more powers for the EU's institutions, but also provided more discretionary powers for national governments. The proposed new fiscal rules allowed member-states to come up with their own plans for debt sustainability, within a commonly-agreed framework. As with NGEU, the Commission would assess these plans according to how well they tackled problems that were identified in its country-specific recommendations. And if national governments did not stick to the plans, there would be enforcement from the centre, but the member-states would have more control over the process.

There was broad agreement that the EU should have a bigger fiscal capacity. It is probably too controversial to give the EU a role in macroeconomic stabilisation through cyclical tax and spending. Covid was *sui generis*, in that NGEU provided transfers between member-states, and that is unlikely to be repeated. A more promising avenue is for the Union to borrow to invest in 'European public goods' – energy interconnections between member-states, energy storage, hydrogen, defence, and support for Ukraine and other foreign policy and defence goals.

Session 3: Are we moving from a labour glut to a labour shortage?

On the eve of the pandemic, unemployment had reached record lows in many European countries, while wage growth and inflation had been modest. Greater competition from low-wage countries, technology displacing manufacturing workers, labour market deregulation, declining trade union membership and higher migration flows may all have played a part in the flatter relationship between wages and unemployment.

Over the pandemic unemployment remained low. Job vacancies are now rising, but so far wage settlements have lagged behind inflation. The EU has absorbed millions of Ukrainian refugees, migration both within the EU and from outside has resumed, and technology allows more services to be provided across borders. But there are reasons to think that, in the future, labour might be less abundant, and workers may have greater bargaining power: global trade integration has been stagnating; societies are ageing, especially in many lower-wage competitors, including China; and re-engineering the energy system, especially insulating buildings, is labour-intensive.

Will labour be scarcer in the future? Might scarcer labour reduce income inequality and induce more productivity-enhancing investment? Or could it raise the risk of stagnation, especially in countries that attract fewer migrants? Might tight labour markets make Europeans more welcoming to immigrants?

Europe is struggling with a very tight labour market: the EU unemployment rate is lower than pre-pandemic levels, and the ratio of vacancies to unemployment has increased in most countries. Furthermore, the drivers of labour market tightness differ in the US and in Europe: for example, one participant noted it cannot be ruled out that the US is facing a one-off wage increase in sectors where workers were simply paid too little.

In the medium-to-long term, there are reasons to believe the growth of global labour supply will slow, which might entail higher inflation and interest rates. Both Europe and China have rapidly ageing populations, and while Africa is experiencing a demographic boom, participation in the global market requires skilled labour and institutional and political stability. Without those things, it is unlikely that Western companies would invest in Africa in the same way they have done in China.

Labour force participation among older workers has risen in the past 15 years, a trend that could mitigate labour scarcity if supported by appropriate policies. Increasing the retirement age remains, however, politically very sensitive both in Europe and in China. Jobs will need to become

more flexible and attractive to older workers, in order to retain them in the workforce. More investment is needed to make care for children and other dependents more widespread and affordable, which would help more parents (sadly, still disproportionately women) to work.

The impact of new technologies on labour markets is less clear-cut than ageing. Automation has replaced certain middle- and low-skilled jobs, while creating new ones. According to which of the two effects prevails there will be varying consequences for job creation, workers' welfare and wage inequality. In the US, a substantial part of the rise in wage inequality in recent decades can be explained by new technology adoption, whereas this explains a smaller part of the rise in Europe.

Technology also tends to make markets more concentrated, and limited diffusion of new technology across firms can further erode workers' bargaining power. Firms with cutting-edge technology attract high-wage, high-productivity workers, whereas those further away from the frontier are less able to offer higher wages to their workers. This leads to inequality in wages between workers doing similar jobs in different firms, which could partly explain regional inequalities, with high-technology jobs becoming concentrated in

some areas. In this case, technical education can increase the supply of high-skilled workers and make it easier for companies down the chain to adopt new technology.

Participants speculated over possible future developments in key sectors: healthcare and building retrofitting would need large numbers of workers, yet jobs in those sectors were not attractive today. The expansion of electric and autonomous vehicles would partly replace drivers, who would need reskilling. The evolution of artificial intelligence might lead it from enhancing skilled labour to ultimately replacing skilled tasks.

Most participants agreed that labour scarcity was unlikely to change Europeans' antipathy towards immigration quickly. The case of Ukrainian refugees in Eastern Europe was an exception, and the extent to which they would settle down there as opposed to returning to Ukraine depended on the evolution of the war. The UK was also a special

case: since Brexit, labour scarcity has already made public opinion more favourable to immigration.

The effect of labour scarcity on wages and, consequently, on income inequality, depends on existing labour market institutions. In the UK, pandemic- and Brexit-induced hits to labour supply have temporarily increased the bargaining power of workers, but other signs indicate that in the longer term labour power will continue to be weak. Despite the public debate about working conditions during the pandemic, the quality and security of low-skilled services jobs are poor, and many workers cannot control how many hours they work. Union membership has been steadily falling among younger workers. Investment in training has been dwindling. Social security support for the unemployed is not much more generous than when former prime minister Margaret Thatcher left office in 1990. An exception is the rising minimum wage, but that does not apply to all workers.

Session 4: What are the economic consequences of energy independence from Russia?

Rapid economic recovery after lockdowns, together with bottlenecks in gas supply chains and a particularly hot summer, contributed to a gas price spike in autumn 2021. Russia's invasion of Ukraine has only increased energy prices, and the EU has vowed to do all it can to curb Russian fossil fuel imports as quickly as possible. For his part, Putin has been withholding gas supplies in order to damage Europe's economy. This will ensure that fossil fuel energy prices remain high during the phase-out, making it harder for politicians to press for tougher policies to reduce emissions (especially if these policies raise energy costs for consumers).

Has the EU made the right decision to phase out energy imports from Russia, rather than imposing a tariff or embargo? How can Europe avoid locking in 'temporary' solutions such as switching from gas to coal, or from piped to shipped gas? How long will high energy prices persist for, and what might be the consequences for inflation and interest rates? How should governments finance investment in clean energy? Should the EU exempt energy investment from its fiscal rules, or create more central funds to help accelerate the transition? How should governments protect citizens from high energy prices?

How will Europe cope without Russian gas? The price and supply shocks have been painful, but Europe has managed well and is on course to avoid energy rationing, primarily thanks to a big drop in energy demand. EU gas consumption has fallen over 16 per cent year-on-year, greatly outperforming expectations. The acceleration in the roll-out of renewable energy, increased gas supplies from Norway, and a rapid expansion of LNG import capacity have further relieved Europe's energy woes.

A key question is how Europe will refill gas storage in the summer of 2023 for the following winter. A full cessation of Russian gas deliveries to Europe by the summer of 2023 is a realistic prospect. But it increasingly looks like Europe can manage without Russian gas. One risk to this scenario is a re-opening of China's economy, which could imply very high Chinese demand for global LNG.

Although Europe has prevented energy shortages, prices will probably remain higher

than pre-war levels for the foreseeable future, posing a fundamental challenge to European competitiveness. Around 60 per cent of European firms report energy to be one of the largest obstacles to their business, compared with only 25 per cent in the US. European gas prices will remain higher than the prices for competing firms in the US, who benefit from an abundance of shale gas. While some European firms can absorb soaring energy bills in the short term, the key question is how they can remain competitive in the long term. An additional risk is that prevailing uncertainty, coupled with tightening financial conditions, might reduce investment in climate mitigation and adaptation. Firms in some countries have coped better than others: to some extent this is a legacy of the global financial and euro crises, which led to diverging financing conditions for firms across Europe. Government support for investment in energy efficiency and the green transition is therefore paramount. At the European level, the REPowerEU program is a good start, but further instruments are needed.

For its part, Russia has avoided a collapse of the ruble and its trade surplus increased after its invasion of Ukraine. But this is mainly due to the revenues generated by high energy prices and import compression. Russia is highly dependent on revenues from energy exports. Oil and gas make up 60 per cent of Russian exports, and the government taxes 70 per cent of the associated revenues. Russia has managed to redirect more fungible oil exports towards other non-Western buyers, but offsetting the loss in gas exports to Europe is more challenging, as most of it is transported by pipelines. Russia is developing a second gas pipeline to China, but it will be several years before it is finished.

The decoupling of the Russian-European energy relationship has also reverberated elsewhere in the world. One underemphasised aspect of Europeans buying LNG at extremely high prices throughout 2022 is the strain this has put on developing countries, to whom Europe has *de facto* exported its shortages. As Europe seeks alternative suppliers of gas, the US has emerged as a leading one: if gas markets between the EU and North America become more integrated, prices will converge,

driving down European gas prices and possibly keeping Europe on a high carbon emissions path for longer. Some participants did not consider this a realistic assessment, however, because, despite American gas exporters asking Europeans to sign very long-term contracts, European buyers have been hesitant to do so.

To overcome its energy challenges, the EU can embark on two overarching political projects that received wide support at the conference. First, the EU needs a much more integrated energy market, a goal that has remained elusive. The market for gas and electricity has not been working optimally across borders. Energy remains a national competence, with EU member-states determining their own energy mix. This seems fundamentally incompatible with the overall political aim of an EU single market for energy. Several participants pointed out, however, that member-states are unlikely to give up their national energy prerogatives. Europe may therefore have to find second-best approaches to make its energy market work better. In this respect, getting rid of national vetoes on building cross-border interconnectors would help. The second political project is transforming Europe's industrial structure. Apart from Russia, Europe is a resource-poor continent. The breakdown of the energy relationship between Russia and the EU means Europe cannot pursue a comparative advantage in energy-intensive industries, at least not until renewable energy has expanded to the point where energy becomes extremely cheap.

The holy grail, clearly, remains the transition towards renewable energy. The costs of installing renewables, including wind, solar and batteries, continue to fall, providing a strong tailwind to Europe's green ambitions. The renewables energy supply boom will start to become visible in the market in 2025-2027.

Investment in renewable energy is highly sensitive to the cost of capital. For some participants, this means that governments and central banks should do much more to use their balance sheets to reduce the cost of capital for green investment. Central banks need to be convinced that lower rates for green assets will serve their

price stability objective. The profound demand for capital during the green transition will, however, drive up equilibrium real interest rates, which means central banks will face pressure to increase nominal interest rates to catch up.

Renewable energy is intermittent, but some participants stressed that is not an impediment to powering over half of the grid with renewables. Nevertheless, to make the green transition work, the ability to store energy is crucial: Europe should aim for an industrial structure that favours developing and producing energy storage solutions. Without sufficient storage during the transition period, energy sources that can provide continuous service will still be needed. For many participants this meant nuclear power. More

constant energy consumption, achieved with smart pricing, would also help. Not all factories run 24 hours a day: harnessing their flexibility in energy consumption would be helpful. A complete flexibility of energy use, however, is more difficult to achieve for households.

At the global level, one key bottleneck to the green transition is rare earth materials. These can be found around the world, but China currently provides around 85 per cent of them and it is not clear whether it will have sufficient capacity to supply Europe. Europe will have to consider mining and processing rare earths domestically if it wants to combine its quest for strategic autonomy with the green transition.

Session 5: Is globalisation in retreat?

The pandemic and the war in Ukraine have caused an upheaval in international trade flows. During the pandemic, international migration all but ceased, sharply reducing trade in services, but goods trade has been undergoing a boom since the end of the first lockdown, as consumers switched spending from services to goods. In the medium term, Covid may accelerate the globalisation of services trade, by proving that more services can be delivered remotely. Covid-related export controls show that governments are increasingly prepared to ignore the trade dependencies of other countries, while the war shows they might also exploit them.

Governments have become more determined to insulate their own economies from the political risks of globalised supply chains – as seen in Europe's rapid efforts to end Russian gas imports. The EU is pursuing a trade agenda that seeks to penalise imports from countries that damage the environment, violate labour and human rights, or compete in ways the EU considers unfair.

To what extent will democracies try to cut their dependence on autocratic rivals, and will they be successful? Will we see increased trade and economic (re)integration within the West? Will fraying globalisation – or even outright disintegration of the global economy – lead to higher inflation and falling real living standards, or might it create opportunities for 'left-behind' regions in Europe? Is the EU becoming more protectionist, or are its attempts to create a more level playing field globally justified? Will that have a material impact on its openness to the global economy?

There was broad consensus at the conference that the pace of globalisation has slowed markedly. Global value chains stopped growing after the financial crisis of 2007-08. Since then, trade openness has been in slow decline, accelerating in the first year of the Covid pandemic.

However, while the pace of globalisation is slowing, deglobalisation has not occurred to any great extent. National economies remain deeply interconnected. There is no single way to

measure deglobalisation and, on some indicators, globalisation is still growing and has proved resilient to recent crises. For example, flows of foreign direct investment are growing steadily. Many of the world's largest economies bounced back quickly from Covid. And in important ways, the pandemic precipitated more globalisation. Global supply chains proved essential for countries to acquire personal protective equipment and vaccines. And the shift in demand away from services and towards goods during the pandemic

meant that China's exports increased dramatically. Globalisation has proved resilient to other recent challenges too. For example, one discussant noted that US tariffs had less impact on trade with China than many analysts had expected.

Rather than deglobalisation, the world might instead be seeing a reconfiguration of globalisation. An example is financial globalisation. Increasing use of sanctions is not necessarily disrupting established global financial flows – the current account surpluses accumulated in China, Saudi Arabia and Russia still finance spending by the US, the EU and India – but it is making these flows more complex and opaque. Another example is the trend towards regionalisation of supply chains.

There are several possible explanations for the shifting form of globalisation. One is that countries and firms are responding to the recent increase in the frequency and severity of economic shocks – such as the European sovereign debt crisis, Brexit, the US-China trade war, Covid and Russia's invasion of Ukraine. Firms now see global supply chains as riskier than they did before, and seek greater resilience and protection from political and economic risks. Another is the shift from a unipolar to a multipolar international order, which means that the US is more eager to focus on its relative advantages over other powers, rather than absolute gains for the global economy. Washington is now focused on protecting its leadership in key sectors and hobbling its competitors. For example, recent US export controls aim to foreclose China's access to key semiconductor technologies in order to constrain China's development. Another explanation is that firms have had access to cheap financing, thanks to a prolonged period of low interest rates, which has meant the cost of capital has declined relative to the cost of labour. That has encouraged greater use of machinery domestically, rather than off-shored production using foreign labour: one discussant posited that robots can be substitutes for global supply chains.

Where decoupling is occurring, in some cases – such as the UK leaving the EU's single market – it encompasses many sectors of the economy at the same time. But most discussants believed this type of broad decoupling was the exception.

Limited decoupling is more common, as countries seek to prioritise resilience in a limited number of strategically important sectors, such as rare earth metals. Yet countries have not adopted any rigorous methodology to assess which sectors are strategic. These decisions are often driven by a combination of national security concerns, corporate interests and other political considerations, such as labour union pressure. These interests converge in certain sectors, such as semiconductors. President Trump imposed export controls to target Huawei, and President Biden has now broadened these export controls to cover chip manufacturing in China more generally. The broadening of these controls was driven in part by American corporates eager to receive government subsidies and labour unions welcoming new domestic manufacturing plants.

For its part, the European Commission has identified a small number of technologies it believes will prove strategically important in the future, and where the EU is behind – or risks falling behind – the US and China. These include artificial intelligence and quantum computing. These fields, like other digital markets, are likely to be dominated by one or two players who can build scale quickly. The EU is therefore focused on helping its firms scale up quickly and innovate rapidly, which have not been Europe's traditional industrial strengths.

Electric vehicles and batteries are also sectors that the EU and US are targeting, for example in America's Inflation Reduction Act. Yet this area, too, has been strongly influenced by labour politics. The shift from traditional to electric vehicles could lead to a sizeable loss of employment in the West.

Some discussants thought that important sectors had been neglected by Western governments. For example, there is no Western consensus on whether the production of active pharmaceutical ingredients or smartphones is strategically important. Yet smartphones can pose significant security risks through cyberattacks, which can be facilitated through vulnerabilities in their component chips, and the West remains reliant on a small number of countries for many pharmaceutical inputs.

As to the impacts of decoupling, these will likely be mixed. On the one hand, its economic impact is unequivocally negative. It raises the cost of traded products and reduces economic growth. Europe will be among the most affected by 'slowbalisation' because of its high trade intensity. The impacts of decoupling will not necessarily be sudden and severe – although the EU will be exposed given its dependency on imports for technology and energy. Nationalist economic policies like Brexit pose long-term problems for the countries that pursue them: UK services trade is lagging, and goods trade with the EU has never recovered from Brexit.

In some cases, however, decoupling might reduce risk and improve the world's resilience to future shocks – for example, where decoupling helps diversify the number and location of global suppliers of important inputs and reduce market concentration. Some discussants felt that governments would need to push for diversification, which would be too limited if it were led by the private sector. This task will prove very difficult and in some cases – like the mining of rare earths – may take decades.

However, some discussants also thought attempts to limit decoupling to a few strategic sectors might prove impossible in practice, and could instead lead to spill-overs into other sectors, creating much larger economic costs. For example, the West's

initially targeted sanctions against Russia have become ever-broader. As a result, the West has discovered that value chains are often far more complex and involve more interdependencies than they had expected. A China-Taiwan dispute would weaponise many intermediate inputs for electronics such as chips, assembled circuit boards, and other electronic components.

Finally, discussants agreed that there were important areas where re-globalisation – or at least a much more energised multilateral order – was essential to address global issues. Mildly encouraging progress has been made on some issues in recent years. One example is the recent OECD-brokered agreement on global corporate tax reform, which almost all countries see as a positive development to address the harm caused by tax havens, a problem which even economically powerful countries have been unable to tackle effectively on their own. Climate change is another example where global co-operation will prove more effective and less economically harmful than unilateral efforts. The EU's carbon border adjustment mechanism, for example, would have far less impact on trade patterns if more countries put a price on carbon emissions. The growing use of subsidies – an issue which is not effectively disciplined by international trade law – remains an area ripe for co-operation. Without co-operation, the dangers to the global economy of strategic decoupling will be much greater.

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