the day after

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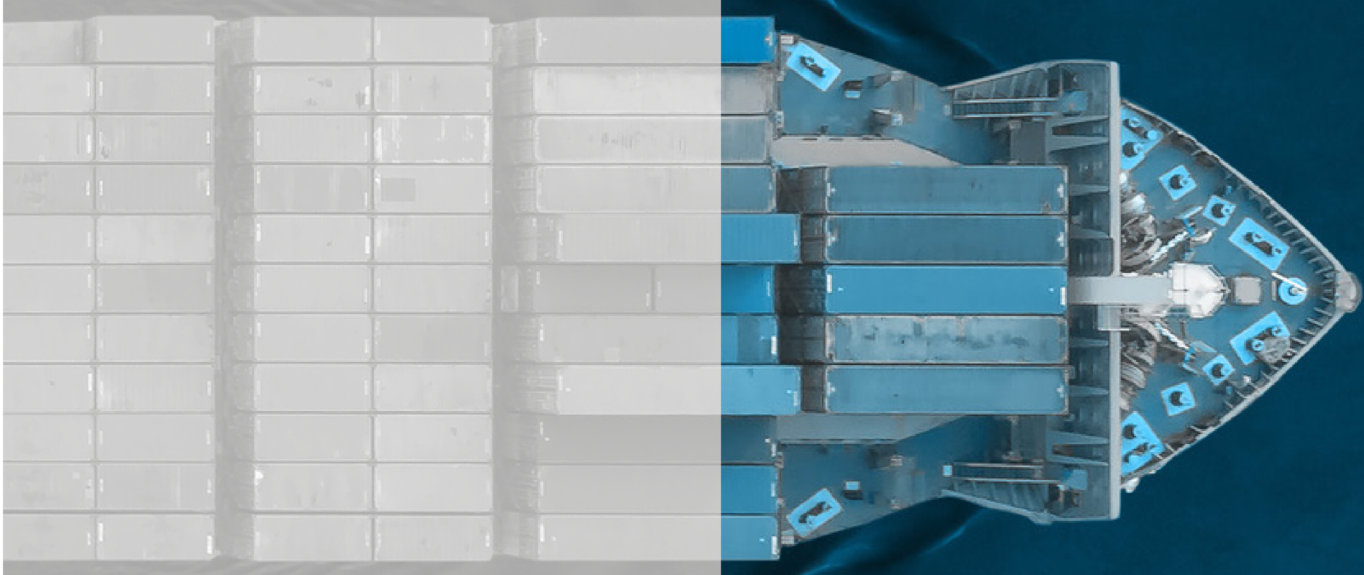
Deglobalisation could improve diversification but also exacerbate financial contagion



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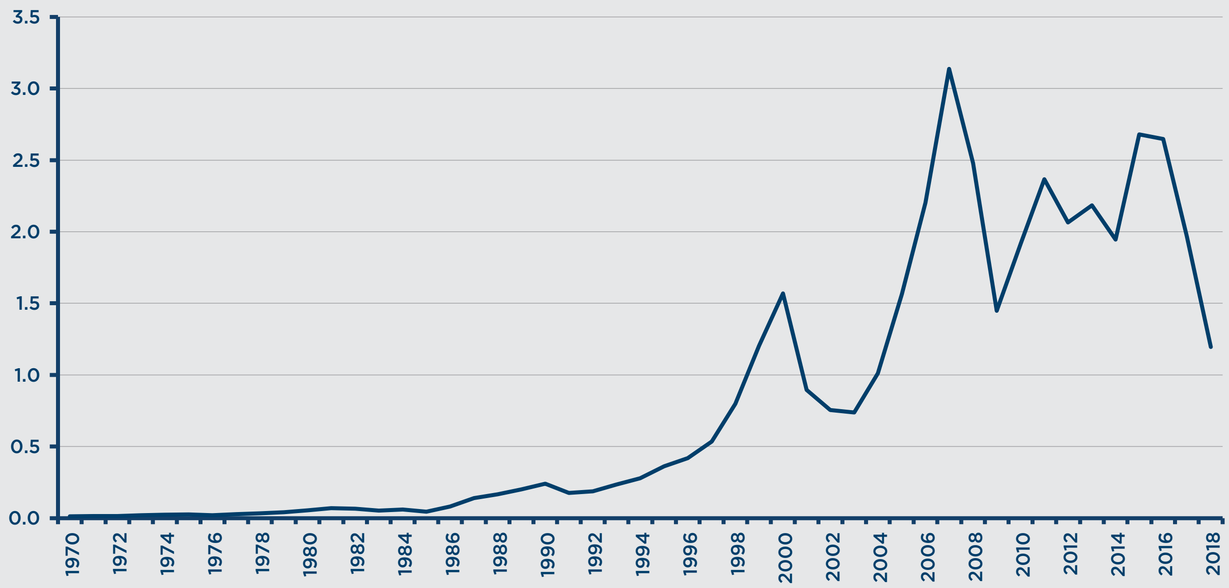
In recent years world trade dynamics have definitely shown an accentuated inversion of the globalisation trend and its robust contribution to global economic performance. The Great Financial Crisis (GFC) marked a historic turning point in the degree of global economic integration. Since 2007/08 global trade has entered a period of increasingly protectionist policies (trade barriers, national subsidies, national champions), decelerating growth in trade-intensive sectors, rising policy uncertainty and more recently, trade tensions.

A compelling example of this reversal in the globalisation trend is shown in Figure 1: the evolution of foreign direct investments since 1970. Foreign direct investments have decreased by 60% since their peak in 2007. Cross-border financial flows have experienced a similar trend (Bordo, 2017).

In 2020, the unexpected advent of the Covid-19 pandemic has simply added momentum to a trend that began a decade ago. In response to the current health and economic crisis, countries are redefining their strategies on economic integration, autonomy in strategic sectors and domestic economic sovereignty, reinforcing the deglobalisation trend. For most countries, the Covid-19 crisis may push them to rethink their dependency in key sectors such as technology (data protection, privacy and national security). As a matter of fact, US and Chinese companies are dominating this sector and the lack of a leading European company at the global level could push Europe to become more defensive and to increase regulations *vis a vis* foreign companies and countries. One of the most sensitive sectors, exposed during the pandemic crisis, has been healthcare: several countries have become aware of their overwhelming dependence on foreign companies and felt an urgency to develop sufficient domestic production of medical equipment and pharmaceuticals. **Among the several fronts of confrontation with China, the US has lately intensified its efforts to reshore the health sector.** Some initiatives have been launched to increase domestic capacity, such as a larger budget under the CARES Act and specific company loans.

This is an auto-fulfilling vicious circle: trade restrictions bring further trade restrictions from other partners. Globalisation is generally accepted to have brought about a general high degree of wealth (though not equally distributed), and it may prove

Figure 1: Foreign direct investments, net inflows (balance of payments, trillion US$)



Source: International Monetary Fund, Balance of Payment database, supplemented by data from the United Nations Conference on Trade and Development and official national sources.

difficult to revert the consequences of the current deglobalisation trend in the absence of strong leadership at the international level that is aimed at maintaining constructive collaboration and multilateralism.

Despite the fact the world is more and more bipolarising in two antagonist power centres, the global multilateral approach is not expected to shatter into hundreds of autarchic countries (isolationism); we still see as a more likely evolution the development of more customised/regional organisations with different power distributions (USMCA, RCEP and CPTPP, to name a few).

The economic deglobalisation process that intensified soon after the GFC did not lead to a similar trend in the financial world. Financial markets around the world remained very much integrated. But if the economic deglobalisation spreads to a financial deglobalisation, this could have a large impact on cross-market linkages, both in the long run and during financial crises, with important consequences for investors looking for diversification opportunities. The historical analysis of equity returns correlations over the last century is particularly instructive. We have experienced periods of varying globalisation intensity. Looking back at less globalised periods, we hope to offer some insights on what could happen in a less financially globalised world.

Financial globalisation, financial contagion and portfolio diversification[1]

Financial globalisation is not a linear or irreversible process. Researchers have shown that international **capital market integration was significantly more pronounced in the 1880-1914 and post-1971** eras than in the interwar (1919-1939) and Bretton Woods (1944-1971) periods (Mauro *et al.*, 2002; Goetzmann *et al.*, 2005; Rangvid *et al.*, 2016). Bekaert and Mehl (2019) studied global stock market integration over the 1880-2014 period. They showed that, although international stock markets were significantly integrated during the first era of global finance of 1880-1914, integration was at its highest level in the post-Bretton Woods era. Hence, financial globalisation between 1880 and 2014 followed a "swoosh" pattern (Bekaert and Mehl, 2019).

By definition, **globalisation is crisis insensitive and refers to a general increase in correlations within asset classes and across geographical areas** (Berben and Jansen, 2005). However, **during financial crisis episodes, we frequently observe a significant increase in cross-market linkages that go beyond what fundamentals can explain** (Forbes and Rigobon, 2002). This phenomenon has been called "contagion" and it has important implications for investors. Investors typically look to benefit from employing diversification strategies. However, in the event of contagion across countries, geographical diversification becomes less powerful during crises, which in turn makes investors with already low returns even worse off.

Financial contagion in the long run

In a recent paper (Accominotti *et al.*, 2020), we examine the linkages between 17 international stock markets from a long historical perspective (1880-2014). We revisit the issue of financial contagion during globalised periods. More precisely, we investigate how the level of financial globalisation affects the risk of international financial contagion. Considering the period between 1880 and 2014 allows us to distinguish between four sub-periods with different levels of financial market integration:

- the 1880-1914 classical gold standard era, when financial markets were globalised but international stock market integration was more moderate than in the most recent period;
- the 1918-1940 interwar years, which saw a short revival in cross-border capital flows followed by a collapse of globalisation;

1. An earlier version of the article (Accominotti O., Brière M., Burietz A., Oosterlinck K. and Szafarz A. "Globalisation and Financial Contagion: A History") was published by the Center for Economic Policy Research Policy Portal (VoXEU) on April 10, 2020: https://voxeu.org/article/globalisation-and-financial-contagion

- the 1946-1971 Bretton Woods period, when stock markets were poorly integrated as most countries implemented capital controls; and
- the 1972-2014 post-Bretton Woods era, when global stock market integration reached its highest level ever.

To overcome the problem of disentangling financial globalisation from contagion, we follow a sequential process. First, we use an international capital asset pricing model to assess globalisation in the equity markets of 17 countries and identify excess returns over the four identified sub-periods with respect to the international market portfolio. Next, we analyse correlations between monthly equity excess returns, comparing correlation matrices by using the tests proposed by Goetzmann *et al*. (2005).

Thus, we measure contagion, not as the absolute level of cross-correlation increase, but as the increase in correlations above what fundamentals can explain[2]. In summary, we allow for the possibility of globalisation associated with the systematic source of return variation, and then we consider overlying contagion.

We show that the intensity of stock market contagion varies with the degree of financial market globalisation, but in a nonlinear way. Intuitively, in a world with high cross-market correlations, the scope for an increase in correlations following a crisis should be more limited than in a world with limited or no globalisation.

Our findings indeed suggest that the phenomenon of financial contagion was absent from stock markets during both the period of deglobalisation of 1918-1971 and the era of intense financial globalisation of 1972-2014. However, we do find some evidence of stock market contagion during the classical gold standard period of 1880-1914, when stock market integration was high but more moderate than in the most recent period.

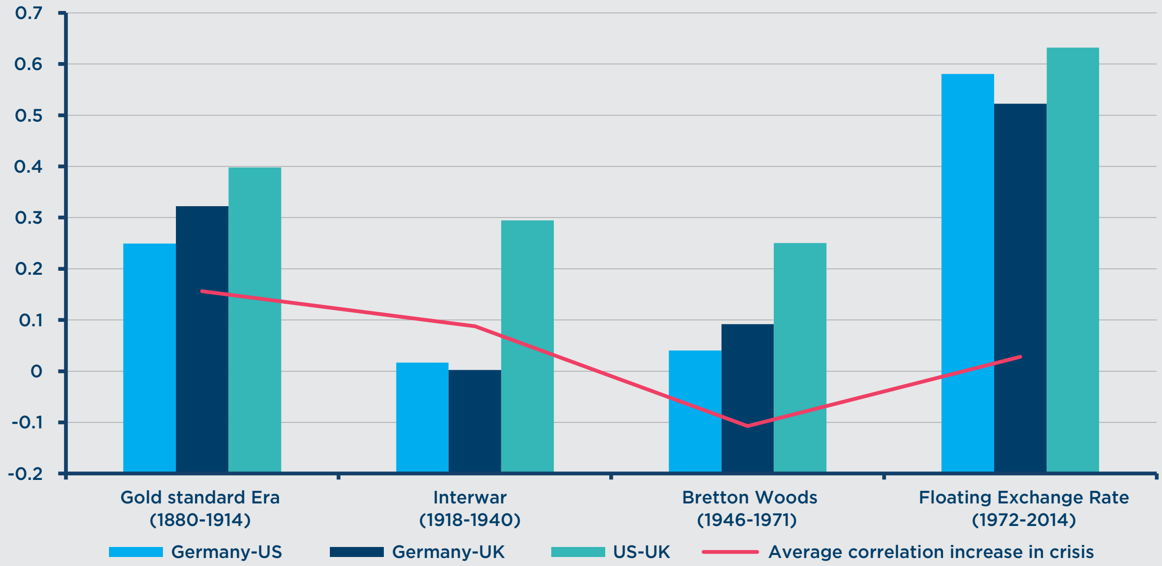
The capital controls and market segmentation implemented from the 1930s to the Bretton Woods years may explain the absence of stock market contagion during the 1918-1939 and 1946-1971 periods. However, although the 1880-1914 and 1972-2014 eras were both marked by significant capital market integration, contagion was only present in the former period.

Figure 2 illustrates the relationship between financial globalisation and financial contagion. The figure reports cross-country correlations between the monthly stock market returns of Germany, the United States and the United Kingdom in four sub-periods from 1880 to 2014. It also shows the average increase in stock market return correlations between these three countries during identified crisis episodes. As is apparent, international contagion on stock markets only appears to have been a significant problem in the era of "moderate" globalisation of 1880-1914, but was a much less severe issue in the era of "intense" financial globalisation of 1972-2014.

For contagion to occur, markets have to be mildly integrated. When connections between markets are minimal, contagion cannot appear. Short of globalisation, contagion is impossible because it requires some permeability between financial markets located in different countries. With peaking levels of globalisation as in the 1972-2014 period, however, contagion is doomed to disappear because when stock return correlations during quiet times are very high, there is much less room for any increase following a shock. **But once markets are more mildly integrated, financial contagion becomes plausible during crises.** During the 1880-1914 classical gold standard era, financial globalisation was reasonably high, highlighting the presence of financial contagion. Overall, contagion is more likely to occur when financial globalisation levels are in the middle range. Our findings are thus consistent with an inverted U-shaped relationship between financial contagion and globalisation.

2. Excess returns are estimated from a CAPM, with a World index weighted by country GDP. Two robustness checks are made, to the CAPM model and to the set of countries included, with similar results.

Figure 2: Cross-country correlations and average correlation increase during crises, Germany, UK and US



Source: GFD, author's calculations.

Conclusion

In the years following the GFC, an economic deglobalisation process started without being reflected at all on financial market integration (financial globalisation). **The ongoing Covid-19 pandemic is likely to cause another 'stress test' for globalisation**, leading to a further rethinking of the interconnected global economy. If one of the consequences is that financial markets will return to a more moderate level of globalisation, **we could expect financial return correlations to be lower during quiet times, thus potentially improving diversification benefits. However, if we come back to a regime close to the one experienced during the Gold Standard Era, we could also expect correlations to increase more significantly during financial crises**, due to increased financial contagion.

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