DUTCH TRANSFORMATION FORUM

Globalization:

It's a small world after all

November 2017

Foreword

Catalonia voted for independence, while Madrid tried to stop it. With emotions running high on both sides of the debate, the question: "what is the right level of governance", is back on the table. This is not the first time we have seen a population choosing to regain control and decrease (supra)-national cooperation. Remember Brexit, last year? That was a democratic choice made by a majority of the citizens to leave the supranational cooperation of the EU. The same nationalistic rhetoric can be found in the winning patriotic narrative of the Trump administration.

Globalization is the worldwide increase in interaction across national borders on social, economic and political dimensions. We all benefit from globalization, but the perceived benefits differ greatly across the population. A sizeable group of people has lost faith in the benefits and will try to stop or even rewind (parts of) globalization.

Globalization is a driver of growth, and the only option for solving truly global issues such as climate change, tax evasion and data security, is global cooperation. Yet how can we get the support that is necessary to tackle overarching issues in times when citizens all over the world are questioning their support for globalization? We believe that both government and businesses have a role to play in this debate.

In this paper, which is divided into three main blocks, 1) Goods & Services, 2) Money & Institutions and 3) Migration & Culture, we first seek to explain globalization and the way it is valued and perceived. Finally, we discuss the challenges that globalization faces today.

The aim of this report is to facilitate an informed discussion at the Dutch Transformation Forum 2017. We invite you to read it and to discuss it with us and others. We are looking forward to having an interesting and stimulating discussion with you,

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Summary

Globalization used to mean a promise of prosperity. Everybody was filled with excitement about the potential benefits and the welfare it would bring. And it did bring welfare, in an unparalleled way. However globalization also had downsides: factories closed, jobs were outsourced and (financial) insecurity increased. A particular group of people incurred a relatively large share of these costs of globalization and have not been sufficiently compensated. This disadvantaged group has been gaining support and subsequently a strong voice in the debate. And now there is, rightly so, a debate on the desirability of globalization and the potential new design of globalization.

We need to ensure that we are not solving yesterday's problems; globalization is changing rapidly. To respond to the challenges of globalization properly, we also need to understand the way globalization is changing in this new phase.

Conventional trade statistics show that the growth of merchandise trade has stopped. Merchandise flows no longer outgrow GDP, because 1) the limits of further international division of global value chains have been reached, 2) the decline of labor arbitrage through the decreasing manufacturing costs advantage in large parts of Asia and the rise in Industry 4.0, will drive the reshoring of global value chains, 3) traditional physical products have been transformed into (free) services and 4) the increase in economic nationalism will decrease the ease of free trade.

At the same time we see a rapid growth of international services, which is not yet fully reflected in trade statistics because international digital value streams are not measured. In this new digital economy global players emerge, especially when business models can fully leverage the network effects at play through their completely digital value chains. Meanwhile we are globalizing from a business model perspective as the same global concepts are rolled out by multiple local players.

Global players will require global supervision and regulation because, in a world with various different regulatory systems, companies will arbitrage differences in, for example, tax regulation and data privacy regulations. When thinking about what kind of regulatory regime will govern the global playing field, we need to be aware that dominance by the West is decreasing and will pass to the East. And with this geopolitical shift, so will the rules of the game.

Those who have monetary power will have political power and China has rapidly become a force to reckon with. Not only is it already the largest Foreign Direct Investment player in Africa, China is also projected to become the largest source of gross capital outflows in the near future. This will influence the global institutional playing field as we know it, through changes in the existing forums such as the UN, the IMF and others, as well as through the launches of new and Asian-led institutions like the Shanghai Corporation Organization.

With the need to govern some global issues on a more global level, more influence and power will have to move to global institutions. This will also mean that governance will move further away from the people who live and work in communities. Meanwhile people's feelings with regard to globalization are changing. Their discontent is not only driven by their perception that they did not prosper through globalization, it is also driven by the notion that their daily lives are changing too fast. They feel as if they have lost control and they are working to regain it. This poses a challenge: how do we move power upward to ensure proper governance in these digital days, while larger groups are withdrawing their support for globalization? This seems like a deadlock, but it is not. Most of the discontented people are not against international cooperation but want a fairer distribution of the cost of globalization and to regain more control. So we need to rethink how this can be achieved.

To revive the enthusiasm for globalization we will need to investigate the options available for compensating those who take the hit when the rest of society collectively benefits, and explore how we can give people more control of decision-making. For example, to move a part of regional or global power to a level where people feel a sense of community. Whether this is through decentralized democracies such as that of Switzerland or by other means.

So, globalization is reaching another phase. In this new era globalization is increasing along less visible axes and thus is not reflected by conventional trade statistics. Government and companies should not be led by the statistics, but should understand the new ways that globalization is now working. We need to jointly design the next wave of globalization, a wave in which all groups in society can continue to enjoy its fruits and the different layers of government can address the pain points in a timely fashion.

Introduction

Many people used to consider globalization to be exciting and something from which we would all benefit. Our definition of globalization is 'the worldwide increase in interaction across national borders on social, economic and political dimensions'. Through imports we received both cheaper products and 'exotic' new products from around the world. This gave us greater choice and lower prices, whilst boosting our purchasing power and raising our living standards. Socially we are more connected today than ever, both transport and communication are more available and more affordable. We used to pay fortunes for a phone call abroad, now it's free via the Internet. We were once proud of our accomplishment of working together internationally. And rightly so, as it has been beneficial to us. Since 1990 there has been an annual 0.3% growth in Real GDP per capita in the Netherlands as a result of globalization.[1]

Most economists would argue that the overall economic benefits of globalization outweigh the associated costs. However, the costs are highly concentrated, while the economic benefits are widely spread across society. For example, many goods and services have become cheaper because they are 'Made in China' - a clear benefit of trade for the whole population. But most people don't make the connection between lower consumer prices and freer trade. What people *do* notice are the factories that closed, and the jobs that were outsourced when production shifted to a lower cost location. Plus, as we argued in the DTF paper of last year, although the inequality of Dutch society did not increase in income statistics, it did increase in a broader perspective.[2] What is not reflected in income statistics is the increased risk profile for those with a lower income through declined job security and a weakened social safety net, plus these statistics do not reflect the effort it takes lower income groups to earn the same level of income. For these people the downsides *do* outweigh the upsides. To illustrate, in the Netherlands, only 22% of the lower educated population disagrees with the statement that *'globalization has downsides for 'people like me',* while 83% of the higher educated population disagrees.[3] This illustrates the need to rethink how we distribute and compensate the costs of globalization.

1 Waard (2014) *Nederland heeft een hoger inkomen dankzij mondialisering.* De Volkskrant. March 27, BCG analysis
2 Blom, Steffens, Brekelmans & Boschloo (2016) *Inclusiveness - in everyone's best interest.* The Boston Consulting Group
3 Continue Onderzoek Burgerperspectieven (2016) *Burgerperspectieven 2016-3.* Sociaal Cultureel Planbureau (SCP)

The income, and thus the welfare, of an entire country is dependent on the relative productivity of those who compete internationally. To explain this let us divide economic activity in two types: tradeable and non-tradeable. The tradeable sector includes goods and services that can easily be traded across borders, and the non-tradeable sectors are not easily traded across borders. Classic examples of tradeable activities include natural resources, agriculture, manufacturing and consulting services. The non-tradeable sector includes construction, and domestic and personal services.

The general welfare of a country is determined by the competitiveness of its tradeable sector. Its relative productivity determines to what extent economic activity is conducted in a country and how it is valued. For example, the income of a farmer is linked to his international productivity: a Dutch farmer earns about 65 times as much as a Thai farmer because the Dutch farmer's productivity is 75 times higher. On the other hand, bus drivers in the Netherlands and in Thailand do not compete on their international productivity. A bus driver in the Netherlands is no more efficient than a bus driver in Thailand, on the contrary; a bus driver in Thailand probably transports more people per bus and probably works longer hours. Yet a bus driver in the Netherlands earns significantly more than a bus driver in Thailand, because their job is location bound. The wages of those who do not compete internationally are determined by the competition on the national labor market, where they compete with those who *do* compete internationally. The income, and thus welfare of the entire country, including bus drivers, lawyers and doctors, is therefore dependent on the relative productivity of those who actually compete with the world in the tradeable sector of the economy.[4]

The share of the population competing internationally is increasing. In the first half of the twentieth century it was almost exclusively the four large Dutch companies who sourced and sold products internationally: Shell, Unilever, AkzoNobel, Philips. Nowadays even Small and Medium Enterprises are sourcing and exporting their services. International competition is facilitated through open borders and international production is facilitated through freer trade. In the early stages of globalization it was mainly entire manufacturing facilities that were moved abroad but, as technology enabled other value-creating activities to move abroad, more pieces of the value chain have begun shifting. Further increases in connectivity and bandwidth will allow us to increasingly have radiologists or data analytics teams to work offsite, converting activities which were formerly non-tradeable, into tradeable ones. This will further increase the share of the labor force which is exposed to international competition. And, for many new tradeable jobs, this will mean more pressure on their salaries and job security.

4 Kurstjens, Maas, Steffens (2012) *NL 2030: Contouren van een nieuw Nederlands verdienmodel.* BCG rapport

Improvement in national economic welfare is built on specialization. While trade can cause jobs to be offshored, it has also created new, more specialized jobs.[5] We have been able to increase our productivity by dividing the production process into ever more specialized parts, which are executed more efficiently through economies of scale and the learning effect. The extent to which more specialization is efficient depends on the size of the market: the bigger the market for products, the more beneficial it is to specialize. With trade opening the door to a bigger (international) market place, trade is an essential enabler for specialization and thus welfare growth.

The increase in economic globalization has been accompanied by an increase in cultural globalization and increasing migration flows in many parts of the world. The Internet has accelerated the spread of global culture that began in the 20th century with radio and television. While initially welcomed with curiosity and interest, the influx of immigrants changing everyday life, and the further integration of the EU have raised deeply-felt concerns about the viability of traditional national cultures, and led to an increase in nationalistic and anti-globalization political movements. Until the middle of this decade these movements were "under the radar". But not anymore. Over the past couple of years, we have seen increasing support for nationalist parties. Most recent are the attempts of Catalonia to become independent, very much a parallel to the Brexit vote that was aimed to regain control. Other examples of attempts to put the interest of "locals" first are the election of Donald Trump in the US, the steady advancement of more nationalist parties and rhetoric in traditionally liberal countries such France, the Netherlands, and, most recently, Germany, where the Alternative für Deutschland (AfD) has made a breakthrough in the most recent elections.

International cooperation is necessary on issues that are not stopped by borders. For example, to effectively take the next step in mitigating climate change, tax evasion, terrorism and data protection, we need further global cooperation. This poses a big challenge for governments. For how can they secure support for the much-needed further international integration, when nationalist rhetoric is winning support?

In this paper we seek to explain globalization and the way it is valued and perceived. We provide an overview in three sections 1) Goods & Services, 2) Money & Institutions and 3) Migration & Culture. Finally, we discuss what the challenges of globalization are today.

5 Hicks & Devaraj (2015) *Manufacturing in America.* Ball State University

Goods & Services

International trade in goods and services is as old as human history. We have records of traders from the classical periods in Persian, Egyptian, Greek, Roman and Chinese civilizations. In the more recent Golden Ages the United East India Company [VOC] set sail from Amsterdam to the Far East to discover new products to be traded on the home market, such as spices, coffee and tea. This was a pattern also practiced by British and French imperialists via the Hudson's Bay Co, the British East India Co, and the French West India Company. To manage the supply of their goods they sent what we now call 'expats' to the orient. And at certain strategic locations these firms opened their permanent 'offices', thus creating the world's first corporations with truly global footprints.

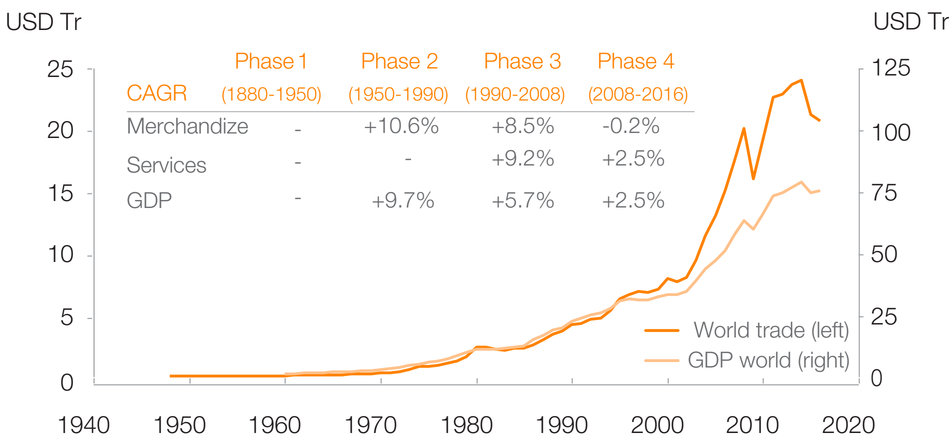
In modern history, globalization of international trade emerged in phases. Since the industrial revolution we can distinguish four phases of globalization:[6]

- Phase 1 was driven by the maritime propulsion technology (steam vs. sail), the expansion of colonialism, and also the industrialization of America. Starting the sourcing of raw materials abroad on larger scale, facilitated through the more efficient transportation options, increased international trade flows.
- Phase 2 started with the recovery after WWII in the 1950s. Factories started mass manufacturing on an increasingly large scale. While production was centralizing, markets for products were also expanding internationally aided by the advent of the GATT and Bretton-woods agreements which facilitated an opening of markets and the introduction of a system of fixed exchange rates.
- Phase 3 commenced in the 1990s with globally centralized factories and was firmly established through the fall of the Berlin wall, the joining of China on the world market and the introduction of the Internet. The global market place opened up and through the Internet the richness of distant communication surged,[7] creating opportunities for further division of the value chain process. This led to continued outsourcing of low-cost manufacturing and services and increasingly globally integrated supply chains.
- Phase 4 is emerging in the recovery of the 2008 financial crisis. Technological developments such as the introduction of new automation techniques, known as "Industry 4.0" and the application of Artificial Intelligence are changing traditional

6 Bhattacharya, Bürkner, Bijapurkar (2016) *What you need to know about globalizations radical new phase.* BCG Perspectives
7 Evans & Wurster (1999) *Blown to Bits: How the economics of information transforms strategy.* Harvard Business School Press

ways of working. These two factors will enable less labor-intensive production and more flexible supply chains. Together with the changing geopolitical context this will lead to new supply chain strategies.

Figure 1: Growth of trade in merchandise & services and GDP[8]



CAGR	Phase 1 (1880-1950)	Phase 2 (1950-1990)	Phase 3 (1990-2008)	Phase 4 (2008-2016)
Merchandize	-	+10.6%	+8.5%	-0.2%
Services	-	-	+9.2%	+2.5%
GDP	-	+9.7%	+5.7%	+2.5%

Although statistics show that trade is decreasing, globalization is not. In line with the above narrative the value of trade has grown in Phase 2 and Phase 3 (see Figure 1) and outgrown GDP growth. However, in Phase 4 we see merchandise trade growing more slowly than GDP, and services trade growing roughly at the same rate. Some people see in these numbers the evidence that globalization is decreasing. But, we do not agree.

First, let us filter out the appreciation of the dollar. As international trade statistics are aggregated in dollars, all international trade flows invoiced in other currencies are converted to dollars. Only about 52% of all trade flows are invoiced in dollars, the other 48% are subject to exchange rates.[9] With the appreciation of the dollar between 2008 and 2016, in terms of exchange rates, the euro amonst others lost 25.4% relative to the dollar.[10] As a result, the trade flows measured in dollars show a decrease that actually not occurred. If we correct for the appreciation of the dollar, the CAGR of trade in goods rises from -0.2% to +1.7% and trade in services from +2.5% to +4.4%, while GDP growth rises from +2.5% to 3.6%.[11]

8 At current prices WTO data, World bank data, BCG analysis
9 Swift (2015) *Worldwide currency usage and trends*
10 Statista data, BCG analysis
11 Swift (2015) *Worldwide currency usage and trends,* WTO database, World Bank database. BCG analysis.

In the following subsections we will explain our argument for why trade in merchandise is decreasing, why trade in services is actually increasing and how we are globalizing beyond conventional trade statistics.

Why trade in merchandise is decreasing

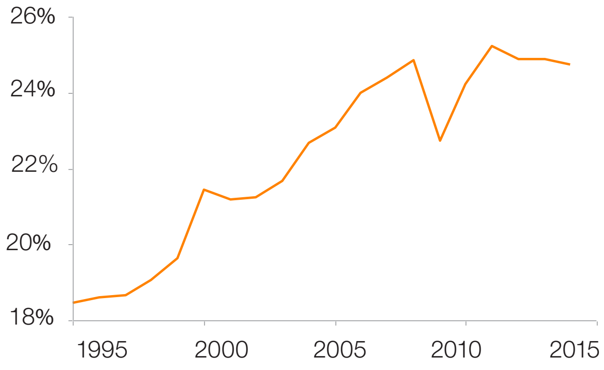
The above section showed that even when international trade statistics of merchandise trade are corrected for the appreciation of the dollar, it is still declining relative to GDP. There are four reasons why we believe the growth of merchandise trade to decrease relative to GDP:

- Moderation of Global Value Chain participation
- Decline of labor arbitrage
- Transformation of products to services
- Economic nationalism

The first reason is the moderation of Global Value Chain participation. This index measures the portion of value added in countries other than the exporting country. An increase in the index shows that an increased share of the value in the value chain is produced abroad. This reflects the extent to which production processes are dispersed internationally. However, it also increases trade statistics, for value added abroad is included every time a(n) (intermediate) product crosses a border in trade statistics. While in Phases 2 and 3 the growth of trade was driven by the increasing dispersion of production across borders, in Phase 4 the increasing share of value added abroad has halted (see Figure 2). Potentially we have reached the optimal level of fragmentation. More dispersion of the value chain is not efficient, because higher levels of fragmentation also include higher transaction/coordination costs.[12] This partly explains the stalled growth in merchandize trade.

12 Jones & Kierzkowski (2001) *A framework for fragmentation.* Oxford University Press

Figure 2: Global Value Chain participation ratio[13]

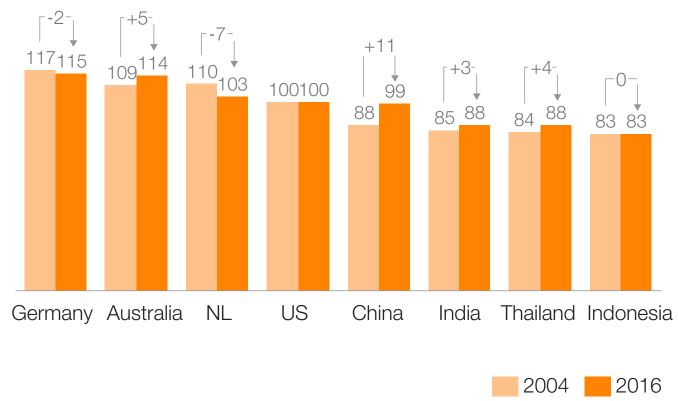


The second reason is the decline of labor arbitrage, which increases the attractiveness of local manufacturing. For years trade has expanded through the outsourcing of merchandise production to lower wage countries. However recent factors such as the relative manufacturing competitiveness of advanced economies and the introduction of Industry 4.0 are changing the trade game.

Emerging markets such as China are losing cost manufacturing competitiveness in relation to some advanced economies (see Figure 3). The relative competitiveness of manufacturing costs depends on the industrial energy costs and the labor costs corrected for productivity. Several of the relatively high cost countries have decreased their manufacturing costs compared to the US, while the lower cost countries are losing their advantage. This has already led to about equal manufacturing costs between China and the US, and for that matter the Netherlands. Even though there is still a ~30 point difference between more expensive and cheaper locations, we expect the future gap to decrease. This would lead to businesses organizing value-adding processes in the value chain closer to home and consequently decreasing the growth of trade flows.

13 Lewis & Monarch (2016) *Causes of the Global Trade Slowdown*. Board of Governors of the Federal Reserve System

Figure 3: Manufacturing cost competitiveness index[14]



Another factor that is increasing the attractiveness of local manufacturing is Industry 4.0, whose implementation is only just beginning. Industry 4.0 is a collective name for highly flexible, data-enabled, and cost-efficient manufacturing processes, boosting productivity, flexibility and innovation. For example, information technology can enable networks of robots to communicate with each other and the supply chain. If robots can automatically adjust production flows to updated delivery schedules, the efficiency of inventory management will increase. With Industry 4.0, the dramatically increased flexible manufacturing will combine the efficiency of mass production with custom manufacturing. In the Industry 4.0 world, labor no longer plays an important role, so offshoring for labor arbitrage becomes less advantageous. On the contrary, production is more likely to be closer to the next step in the value chain or the consumer, which implies lower transport costs and a shorter time to market.[15]

The third reason is the transformation of products to services. Digital propositions are replacing physical propositions. For example, we used to buy a TomTom navigation system to navigate to our destinations. However, the navigation functionality of Google Maps is a free replacement. Whenever we are using Google Maps as opposed to TomTom the outcome is the same, but it will be measured differently in conventional trade statistics. Where the TomTom's value will be incorporated in trade of goods, the free service of Google Maps is not. Furthermore there is a growing increase in 'servitisation': companies are moving from one-time asset sales to ongoing streams of revenue from services and pay-for-performance. For example, the provider of an MRI scanner no longer charges per MRI scanner, but per performed scan.

14 Global Manufacturing Competitiveness Comparator (GMCC). BCG proprietary tool
15 Sirkin, Zinser & Rose (2015) *Why advance manufacturing will boost productivity*. BCG perspective

The fourth reason for the decrease in global trade in Phase 4, is the rise of economic nationalism. Firstly, despite all efforts of the WTO to decrease trade barriers, in 2016 more restricting than liberating measures were implemented: 500 protectionist measures versus 300 trade liberating measures.[16] Furthermore, global trade is subject to increasing tariffs. By joining the WTO, countries commit to levying the same tariffs on all WTO nations, which are the Most Favored Nation (MFN) tariffs. What the MFN system does not stipulate is that tariffs between trading nations have to be reciprocal, and indeed the tariffs do vary greatly between nations. For example, the MFN tariff on vehicles that the US levies is 2.5%, while China levies 25%. When comparing average tariffs we find that China (9.9%) and India (13.4%), whose importance is growing in world trade, uphold higher tariffs than, for instance, Europe (5.1%) and the US (3.5%).[17] Both of the above reasons hinder the growth of international trade.

This does not mean that we should strive for the complete abolishment of all costs related to trade so that we can arrive at a level Dani Rodrik describes as 'hyperglobalization':[18] the integration of the world market as one national market, in which all transactional costs related to international trade and finance are abolished. Rodrik argues that there is a trilemma between democracy, national sovereignty and 'hyperglobalization'; we can have two of these but not three. Because political legitimacy is organized at national levels and we do not want to abolish democracy, we will not give up our national sovereignty and allow a global institution to regulate the international market place. This implies that we cannot successfully operate 'hyperglobalization' with both democracy and national sovereignty intact. If we do want to achieve a state of 'hyperglobalization', we will have to give up either democracy or national sovereignty. Rodrik makes a plea for a world where globalization serves the social and economic needs of a country; the elimination of trade barriers should be a means, not an end. He argues that we should give countries more space to devise their own social and economic policies.

16 Bhattacharya, Khanna, Schweizer, Bijapurkar (2017) *The new globalization; going beyond the rhetoric*. BCG perspective
17 WTO data
18 Rodrik (2011) *The Globalization Paradox*, Oxford University Press

Behind conventional trade statistics

The measured international trade flows in conventional trade statistics do not necessarily reflect the exact value of goods and services that have crossed borders. For example, the US and the UK report a trade surplus with each other.[19] And, on a worldwide scale, countries report 475 billion more exports than imports.[20]
There are several factors to keep in mind when reading conventional trade statistics, we just want to point out two of them:

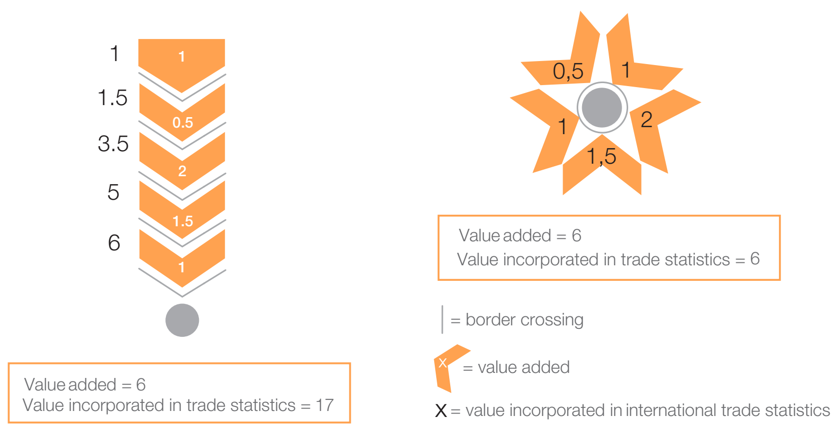
Multinationals clutter the view: Multinationals do not necessarily have traceable cross-border value flows. For instance, imagine a multinational with its headquarters in the US that sends customer data from Brazil to India for analysis. The findings of these analyses improve sales force effectiveness in Brazil. There has been a cross-border transfer of value from India to Brazil, yet the only value incorporated in international trade statistics is (potentially, but unlikely) the invoice from India to the US and the invoice from the US to Brazil for the services. Thus statistics will show no relation between India and Brazil, which is where the real value transfer took place. Moreover, it is highly likely that the cross-border values were not registered, as they will have been "netted" with intercompany other costs or revenue streams. For example, Transwire, a company that facilitates international money flows, cancels out the incoming and outgoing credit in a country. Thus showing no or just marginal cross-border flows, while huge flows are actually taking place.

Increased share of services in the international trade mix, decreases trade growth:
In a sequential fragmented international supply chain, added value is measured multiple times in the international trade statistics, with every extra intermediate border crossing. This increases the trade statistics without increasing the added value produced abroad (see Figure 4). Traditional merchandise trade is often organized as a sequential value chain. In the simultaneous dispersed international value chain only added value is incorporated in international trade statistics, as the added value is directly transported to the country of consumption. Digital services are more often organized as a simultaneous value chain.

19 Romei & Cocco (2017) *UK and US report trade surplus with each other.* The Financial Times. September 24
20 World Bank data, BCG analysis

In the situation where the same value is added abroad, the statistics will measure more value when a product is produced in a sequential rather than simultaneous value chain (see Figure A). Therefore a relatively larger share of international services trade will lower overall conventional trade statistics.

Figure 4: The value of trade flows in a sequential and simultaneous value chain



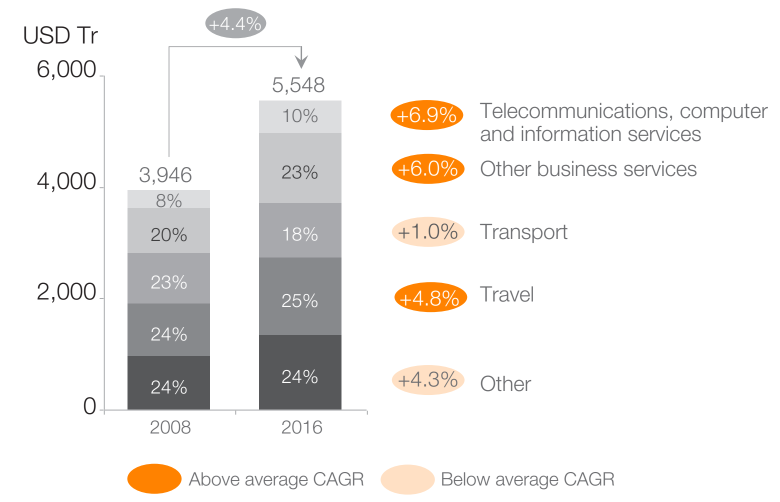
Why trade in services is actually increasing

The trade in services shows a different pattern, for it is increasing, although this is not fully reflected in trade statistics. We would expect trade in services to be surging, with the increased implementation of digital opportunities and the rise in tourism. Netflix, for example expanded within 7 years to 190 countries. Cross-border data flows grew 50% annually between 2005 and 2014,[21] meanwhile the number of tourists worldwide increased from 800 million to 1200 million.[22] But we do not see these developments expressed in conventional trade statistics; the reasons are twofold.

Firstly, Figure 5 shows that the CAGR 2010-2016 of service trade subcategories differs greatly. *Transport*, which is heavily correlated with merchandize trade, has only grown 1% year on year. While *Telecommunication, computer and information services,* tourism and *Other Business Services,* which include R&D, law and consulting services, have grown some 5-7% a year.

21 Luxton (2016) *This phenomenon has boosted global GDP by 10% in 2 years.* World Economic Forum. May 30
22 OECD data, BCG analysis

Figure 5: CAGR of service trade subcategories, corrected for dollar appreciation[23]



Secondly, digital cross-border value streams are huge and increasing. However the real value of these digital trade flows is not, yet, included in conventional trade statistics. To explain this let's go back to the example of Google Maps. The navigational service is free, which does not mean there is no value transaction taking place while using Google Maps. You receive the 'free' service by paying with your data. These valuable data points are collected every time you click anywhere, search something or use GPS services. This data is collected and sold to advertisers. As Google uses your data to sell at a later point in time, the cross-border flow of data is considered to be an export. However, this data stream will have no value represented in trade statistics.

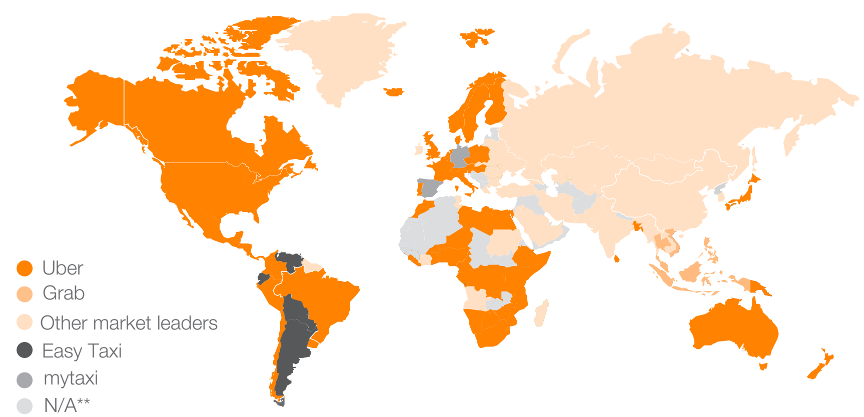
With the exclusion of valuable data streams from conventional statistics we are not only missing value in conventional trade statistics, we are also hollowing our tax system. Why should a farmer pay export duties when exporting his self-picked apples and Google not pay export duties over its self-picked data? If data is the new gold, then we need to rethink how we tax the mining and export of data. For example, Arnold Smulders, professor of the University of Amsterdam, argues that governments should levy VAT taxes on clicks by assigning a virtual value to a click and applying VAT to the 'click-revenue' collected in this way.[24]

23 WTO database, World Bank database. BCG analysis. Corrected for depreciation of the dollar. Estimated that 51.9% of international trade is invoiced in dollars. Swift (2015) *Worldwide currency usage and trends*
24 Rolvink Cousy (2017) *Geef elke klik een waarde, reken daar btw over.* FD media groep. September 13

How we are globalizing beyond conventional trade statistics

In our ever more digital world, we are globalizing through the use of digital platforms, both through global winners and local adoption. With the rise of digital platforms, (semi-)global monopolies emerge: e.g. Google, Uber, Amazon. However, we tend to overestimate how much of a global winner these players are. Google is definitely the market leader in almost every country, however three countries are outliers: China, Russia and South Korea.[25] Meanwhile, Uber has several competitors which have taken market leadership positions around the world (see Figure 6). Uber's main competitors include Grab in South East Asia, Easy Taxi in South America and MyTaxi in Europe. In fact, Uber has not been able to win the countries with the biggest markets outside of the Western world, namely India, Russia and China. In terms of on-line retail platforms, Amazon is only present in 11 markets. It is the absolute market leader in the US (43% share),[26] but it has far from a market-leading position in the UK (16%)[27] or Germany (13%).[28] Alibaba (57% share)[29] is the leader in China and Amazon is only striving for the lead in the Indian market where it is head to head with Flipkart. Meanwhile in South America, MercadoLibre is the clear incumbent.

Figure 6: Market leader ride hailing apps[30]



25 Return on Now (2016) *2015 search engines market share by country*
26 Business Insider (2017) *Amazon accounts for 43% of US online retail sales. February 3*
27 Ecommerce News Europe (2017) *Ecommerce in the United Kingdom*
28 Ecommerce News Europe (2017) *Ecommerce in Germany*
29 Chadka (2017) Alibaba's Tmall Maintains Reign Over China's Retail Commerce. eMarketer.Retail
30 Android app Data July 2016. Source: Marciano (2016) *Who runs the world? Uber! SimilarWeb*

Companies can only become global winners when they are not bound by local economies of scale. They can fully ride the network effects, when they have a fully digital value chain, e.g. no physical outlets or local assets that require utilization and/or scale. Good examples are Google, Netflix and Booking.com. They can leverage their learning from one market to the other to improve their algorithm and are only limited by regulation or language barriers. For example Google lost in China to Baidu because of (amongst other things) protectionist measures. On the other hand, in South Korea, Naver won, because it had adapted its algorithm more closely to the Korean language.[31]

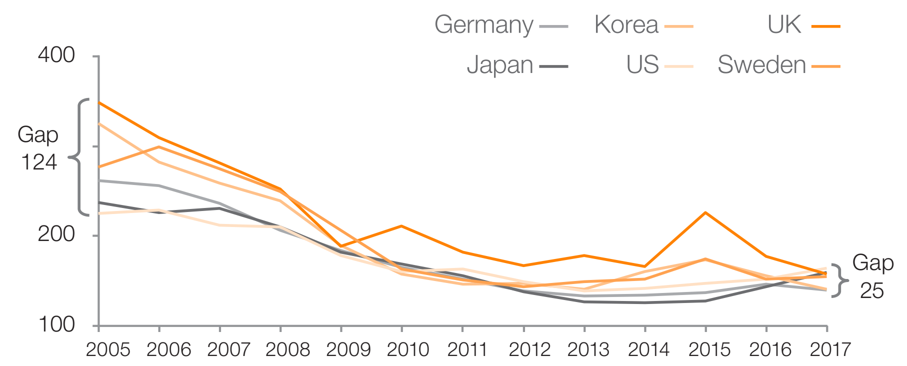
When the business model of a platform is partly physical, it is hard to become a global winner, as the local component will give a local advantage to local players. To illustrate, although Amazon has a digital platform, their distribution is still a physical operation, which gives local players the local advantage. The same is true for Uber, their algorithm is built on Google Maps, however in China, Russia and Saudi Arabia Google Maps is restricted and therefore not the best navigation tool, giving local players the local advantage. Furthermore when global network effects are limited, the first mover advantage gives the first entrant – often a local player – a significant advantage.

Even though semi-physical platforms may not necessarily lead to global leadership, we do in fact globalize from a business model perspective. While Indonesians may not use Uber, they will use Grab which works in an equivalent manner: a platform which matches taxis to customers. The same is true for search engines and online retail platforms. This results in a uniform change of the industry, with different local players: local adaption of global concepts.

Also our products are more and more alike, thus more globalized, but this too is not reflected in international trade statistics. Lifestyles are converging: more and more indigenous people are wearing Western clothing, Justin Bieber is known in every country around the world and the quality of products is converging. For example, a generation ago, if you wanted a reliable car, you would choose a brand which was known for its reliability. Nowadays, cars from most of the major auto-producing countries are about equally reliable, decreasing the gap in vehicle dependability by about 80% (see Figure 7).

31 Krush (2016) *Google vs. Naver. Why can't Google dominate search in Korea?* Link-assistant.com

Figure 7: Problems per 100 vehicles in 3 years[32]



Summarizing, we see that trade in goods is decreasing, while trade in services is increasing even though conventional trade statistics do not reflect this growth. With the rise in digital services, companies have the opportunities to create global platforms. But who regulates these global platforms? In the next chapter we will examine how globalization changed the international money flows and global institutions.

32 J.D. Power. Vehicle Dependability Study, BCG analysis

Money & Institutions

We are used to a world in which the Western countries are the most advanced, most wealthy and most geopolitically-dominant. If we go back 500 to 2000 years, world GDP was directly correlated to one basic factor: population. Before the Renaissance and the Industrial revolution, everyone on the planet had essentially the same education and the same technology. Farming was manual, or with animal power – everywhere. Manufacturing was done by artisans – everywhere. Education was conducted by religious authorities and available to a privileged few – everywhere. The rise of printing, industrialization, mass public education, improved sanitation, public infrastructure, and financial institutions in the Western world created the possibility of making a significant increase in productivity and therefore wealth levels. Years later, virtually every sector in the advanced world was benefiting from all this. Meanwhile, in huge parts of Asia and Africa, the tools of the economy were not too different from what they were in the year 1000.

Towards the end of WWII 43 countries agreed on the creation of the International Monetary Fund (IMF) and the World Bank, at Bretton Woods, a resort in northern New Hampshire, USA. Their aim was to rebuild the post war economies and to promote international economic cooperation. A few years later, in 1947, the General Agreement on Tariffs and Trade (GATT) was established in Geneva, among 23 countries. Under the system established by these institutions, the post-war era of financial globalization was characterized by a strong upswing in international capital flows, mainly between a small number of advanced economies at the core of the Bretton Woods system.[33]

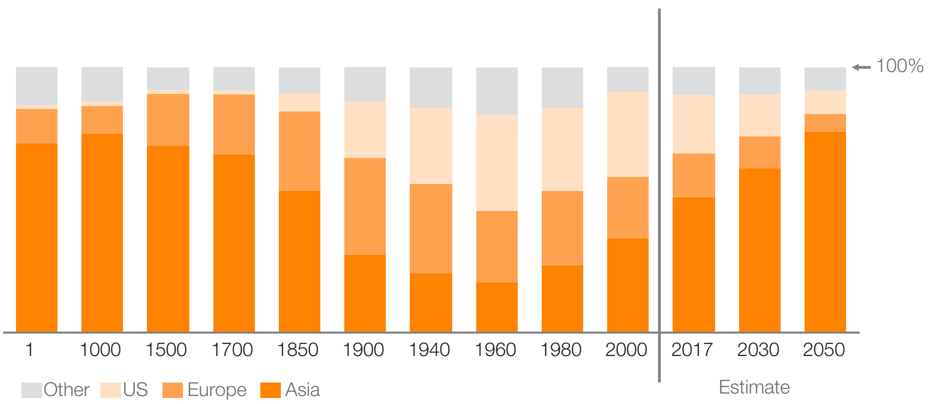
In 1994 the World Trade Organization was created by 123 countries, which built on the GATT, and included new mechanisms for trade-related investment protection and trade dispute settlement. Since the creation of the WTO, global gross capital flows have generally grown more rapidly than net flows and economic output. This indicates that interconnectedness has increased, for the flow of money is increasing more than the trade surplus or GDP. Initially, this trend was mainly an advanced country phenomenon, but developing countries have begun to follow a similar pattern.[34]

33 World Bank (2013) *Capital For The Future: Capital Flows in the Third Age of Financial Globalization*
34 World Bank (2013) *Capital For The Future: Capital Flows in the Third Age of Financial Globalization*

The 2008 financial crisis was an example of how financially interconnected countries had become. Following the insolvency of Lehman Brothers, other global financial institutions and banks were also in danger of becoming insolvent. With the near-default of Greece, other countries risked losing money on their Greek sovereign debt holdings and, because of this perceived increased risk, companies reduced Foreign Direct Investments (FDI). Although the economy has picked up again, risk management has changed the way Western institutions, banks and companies operate. For example, European banks are now consciously decreasing foreign liabilities.[35]

We can see these historic developments unfolding in Figure 8. Europe steadily increased its share up to the end of the 19th century, then the US started gaining ground, which peaked in the recovery after WWII. Now Asia is ready to rise again and is expected to take back its long-held share of the world's GDP. To illustrate, by 2021, China's consumer economy is expected to reach $6.1 trillion which is bigger than the consumer economies of Germany, the UK and France combined.[36]

Figure 8: Share of world GDP (PPP) %[37]



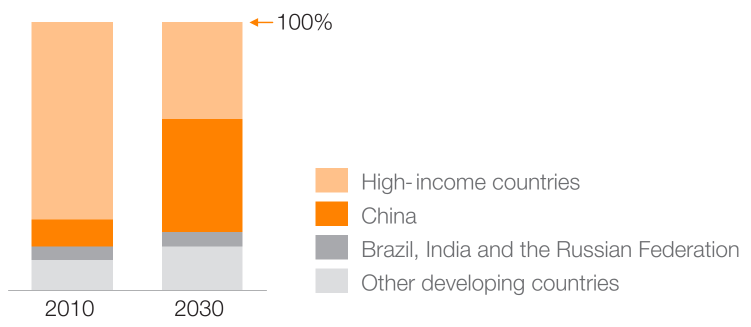
35 ECB (2017) *Financial integration in Europe*
36 Maggard, Khanna, Rose & Walters (2017) *Adapting to a new trade order.* BCG perspective
37 Source: The Economist (2012) *Mis-charting economic history: more than 2000 years in a single graph,* BCG analysis. Includes the assumption that growth after 2008 has increased by 2% for US and Europe, 4% for others and 6% for Asia

The geopolitical shift will change the rules of the game. The current leading institutions in the world were all created in times when Western countries led the world in terms of economic and military power and they are founded on Western norms and values. With the rise of Asia, this will change. China and other emerging countries founded the Asian Infrastructure Investment Bank (AIIB) and the National Development Bank (NDB). For example the AIIB has set a target to lend $10 to $15 billion per year, which is significant enough to signal a shift in power away from the incumbents: the World Bank and the IMF.[38]

China and Russia also started the Shanghai Cooperation Organization (SCO). This is a Eurasian cooperation initiative, which started as a safety organization to demilitarize borders, but now also includes political and economic cooperation.[39] Part of its goal is "moving towards the establishment of a democratic, fair and rational *new* international political and economic order",[40] which illustrates their motivation to change the current world order of the UN. The council is currently comprised of eight member states (including China, Russia, and India) and four observer states. Meanwhile, it is in conversation with six other nations, including Turkey, about participation. However, while experts on the one side say the organization is an anti-US bulwark in Central Asia, experts on the other side believe frictions among its members will hinder a strong, unified SCO.[41]

The rise of Asia will also have an implication for the flow of capital. The World Bank made a prediction regarding the global gross outflow of capital in 2030. Gross capital flows indicate the total value of money flowing out of a country through for example FDI, portfolio investments and bank lending. The World Bank predicts that Chinese capital will quadruple its share of total gross capital outflows in 2030 (see Figure 9), thereby taking the number one spot from the current High Income countries.

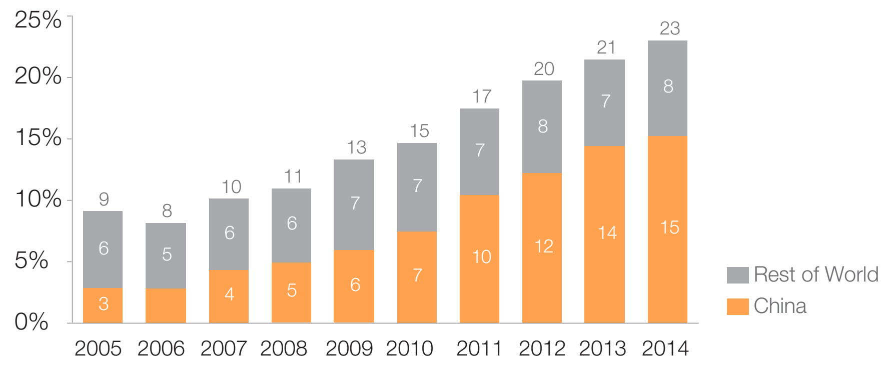
Figure 9: Changing shares in the global gross capital outflows, 2010 to 2030[42]



38 Bhattacharya, Bürkner, Bijapurkar (2016) *What you need to know about globalizations radical new phase*. BCG perspective
39 Albert (2015) *The Shanghai Cooperation Organization. Council on Foreign Relations*. October 14
40 Website of The Shanghai Cooperation Organization: www.eng.sectsco.org
41 Albert (2015) *The Shanghai Cooperation Organization. Council on Foreign Relations.* October 14
42 World Bank (2013) *Capital for the Future: Capital Flows in the Third Age of Financial Globalization.*
Note: this is the gradual scenario

Asian capital will change the business world for one because it has a larger share of state capitalism and because it has an elaborate agenda for strategic investments. State Owned Enterprises (SOEs) are companies in which the government has a 50%+ stake. SOEs are growing tremendously, their share increased from 9% of the Fortune 500 in 2005 to 23% in 2014 (see Figure 10). This is mainly driven by the Chinese State Owned Enterprises whose share increased from 3% in 2005 to 15% 2014 showing that the Chinese have more and faster growing state owned firms.

Figure 10: Number of State-Owned Enterprises as % of Global 500[43]



The largest strategic investment, the "Belt and Road" ("One Belt One Road") program is being led by China. Its aim is to connect Asia, the Middle East, Africa and Europe, both physically through an infrastructure network of railways, pipelines and ports, and through political co-operation. China plans to revive both a land-based "silk road" through the Middle East and a maritime "silk road" through the Suez Canal. China proposes to actively help develop the infrastructure and plans investments of $900 billion.Their projects are designed for the host country but are mainly executed by Chinese companies and Chinese labor.

China is also strategically investing in raw materials and has become Africa's largest trade partner, greatly expanding its economic ties to the country[44]. In 2016 China became Africa's single largest contributor to Africa's FDI[45].

43 PWC (2015) *State-Owned Enterprises. Catalysts for public value creation?*
44 De Jong et al. (2017) *A road to riches or a road to ruin? The geo-economic implications of China's new Silk Road.* The Hague Centre of Strategic Studies
45 fDi Markets data, BCG analysis

The increase in state capitalism will change the way that business is done. National institutions as well as companies with strong links to governments are more likely to request offsets: a minimum component/investment requirement or other local requirements. For example, in order to win a large contract for the Indian Railway Company, GE had to invest in a manufacturing unit at a relatively unattractive location in India.[46]

It is generally believed that small countries like the Netherlands are better off with supranational organizations such as the WTO and the European Union. In a world without these supranational institutions the strongest countries will set the global level playing field, economically, politically, and militarily. The Netherlands has an open economy, but we are not a global power. Without supranational institutions we would lose influence to shape the international playing field in trade agreements (WTO), politics (EU) or finance (ECB). When for example China, the US and Germany define the rules of the game, all the other small countries are left to follow, navigating among the rules and institutions set by the stronger few.

Although the WTO and UN do facilitate the global level playing field to a fair extent, they do not regulate, amongst other things, data protection, true price calculations for pollution, corporate taxes, etc. This is increasingly important in our increasingly digital world, where physical border are less stringent, the climate is visibly changing, and multinationals are more geographically footloose. There are, however, no global institutions defining global rules. When companies have to obey multiple (supra)-national laws, they will find opportunities for arbitrage, as we see happening with corporate taxes. Thus the only solution to avoid arbitrage is global, uniform regulation, without opportunities to deviate. Therefore we need global institutions who can set the global level playing field and this will mean we will have to give up some national sovereignty to ensure all countries comply with these global rules.

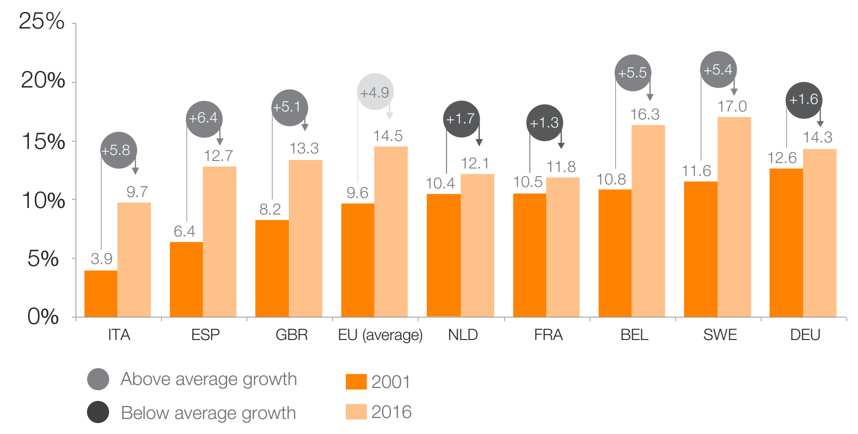
To conclude, we are also financially more connected internationally than ever. As financial power shifts from West to East, so will political power, and this will change the way we do business. There are international issues which need to be addressed globally, like data protection, climate changes and corporate taxes. To do this we need to give up more national sovereignty. But how can this be done when the public support for globalization and supranational cooperation is decreasing? In the next chapter we will examine how globalization has influenced people and culture.

46 Mann & Spegele (2017) *GE, the ultimate global player, is turning local.* The Wall Street Journal. June 29

People & Culture

The cross-border movement of people is also part of globalization. People either move with the intention of returning home in the foreseeable future, such as tourists or business travelers or they go with a more permanent intention: migration. In this globalized world people travel more than ever. However, migration is not, in any sense, a recent phenomenon, it has occurred in all ages. In the Golden Age, for example, one in ten people in the Netherlands was foreign-born. In Dutch towns such as Amsterdam this could be as much as one in four[47], which is comparable to the statistics today. The greatest international migration in history occurred in the 19th century, with many Europeans leaving the continent and seeking a better life and better economic perspectives overseas.[48] This outflow continued in the dawn of WWII, and it is only over time that the direction has changed. Now European countries generally experience net immigration: more people arriving than leaving. The percentage of the foreign-born population in Europe changed from 9.6% in 2001 to 14.5% in 2016 (see Figure 11). The Netherlands is close to, but somewhat below, the average with 12.1% of foreign-born population. Also, the increase has been considerably more moderate than the EU average, with just a 1.7% increase versus an average of 4.9%.

Figure 11: Foreign-born population in European countries[49]



47 Schrover (2004) *Migration: a historical perspective.* BBC news. March 23
48 Evans, R (2017) *Migration: an historic perspective*
49 OECD data (2001), Eurostat data (2016), BCG analysis. Foreign-born population in Germany is approx. +1% higher in OECD versus Eurostat statistics in overlappig years. Therefore 2016 is Eurostat +1%

People have different reasons for migrating. We distinguish four categories: work migrants, family migrants, asylum seekers and others. Countries are not equally welcome to all immigrants. Nobody mentions the higher educated immigrant from England or the international student from Germany, but people are not in favor of the 'Polish taking our jobs' or the 'economic refugees taking advantage of the system'. In the Netherlands we have seen a recent, short spike in the number of humanitarian immigrants as a result of the war in Syria. In 2015 the number of asylum requests grew to 45 thousand but, by 2016, it had already decreased to 21 thousand.[50]

Hence, an inflow of migrants is not new, but what has changed is the cultural composition of the Dutch population. Not only did the share of the population with a migrant background increase, but the people arriving came from countries which have a relatively large cultural gap compared to our own, like Afghanistan, Syria and Eritrea. And that does bring more difficulties. As Robert Putnam, the American political scientist, describes: good societies are characterized by high levels of trust and social capital: the existence of networks and institutions to make it easier to cooperate for the common good. High levels of immigration and ethnic diversity reduce familiarity and therefore trust, at least in the short-term, especially when the people arriving come from places that are culturally distant.[51]

Although the influx of immigrants in the Netherlands is not large as a percentage or numerically, it still changed the composition of the Dutch population. In 2015 22% of the population had a foreign background, which means that either they or one of their parents was born abroad. This is an increase of 5% points from 2000. This percentage is higher in the three largest cities where 52% of the population has a foreign background, versus the smaller villages of the Netherlands where only 13% of population has a foreign background.[52]

Next to the offshoring of jobs, immigration has been - unfairly - scapegoated in the debate on the desirability of globalization. In the introduction we described how it are mainly the lower income groups who feel they have not profited from globalization. And while they have benefitted, it is true that they have incurred more cost; it's been predominantly their jobs which have been outsourced. Plus, as we argued in last year's DTF paper, the inequality of the Dutch society did not increase in disposable household income, however it did increase when one examines the social perspective.[53] Because of decreased job security and a smaller social safety net, those at the lower end of the

50 CBS data, BCG analysis
51 Goodhart (2017) *The road to Somewhere.* Hurst & Company publishers
52 3 large cities: Amsterdam, Rotterdam & The Hague. Small villages <50,000 inhabitants. CBS data, BCG analysis
53 Blom, Steffens, Brekelmans & Boschloo (2016) *Inclusiveness - in everyone's best interest.* The Boston Consulting Group

income distribution have seen a significant increase in their risk profile. Immigrants are not the driver of these developments, but they do manoeuver where the pain is. The lower income groups feel competition from new immigrants for their jobs and they blame immigrants for taking advantage of the social safety net, leaving less for them. But they also blame the rich for taking more than their fair share. One of the reasons why the public eye is on top incomes.

We think there is another reason why some groups in the population are losing their enthusiasm for globalization which is described by David Goodhart in his book 'The Road to Somewhere'. He describes the growing divide between the "Anywheres" and "Somewheres". "Anywheres" are indifferent to whether they live in Rotterdam, Amsterdam or Utrecht, while "Somewheres" typically live within 20 miles of where they lived when they were 14. "Anywheres" are often urban, socially-liberal, university-educated, in the upper quartile of income, and are geographically footloose. They are the global citizens clearly seeing and taking advantage of the benefits of globalization. Meanwhile the "Somewheres" are rooted in a specific place or community, usually a smaller town or in the countryside. They are socially more conservative, often less educated, on a middling income, and have deep connections to local traditions and social structures. This large group of citizens is discontent with globalization for both cultural and economic reasons. They have a sense that their hometown has changed, or is in the process of changing, at an unnervingly fast pace. This group does not oppose immigration as such; they oppose mass and rapid immigration. David Goodhart estimates that 50% of society are "Somewheres", 25% are "Anywheres" and the rest are something in between. Even though the "Anywheres" are outnumbered, the "Anywheres" are generally overrepresented in national politics and media and fail to understand the "Somewheres". This is illustrated by the response to the question *"politicians do not care much about what people like me think".* Sixty-eight percent of the lower educated population agreed, compared to only 30% of the higher educated population.[54] David argues that the "Somewheres's" discontent is not entirely illiberal but partly a response to the dominance of the 'Anywheres'.

To conclude, there is no question that immigration has changed society as we know it. And while immigration itself is not new, together with all the other changes, the daily lives of many are changing a lot and they are changing fast. This feeds the discontent of those who are not thriving in the globalized world: the "Somewheres". Their discontent is not understood by the "Anywheres", who generally set the tone in the media and the direction of public policy. However, in democratic processes the "Somewheres" can and will voice their opinions, which has led to outcomes which surprised the "Anywheres": Brexit, Trump.

54 COB (2017) Continue Onderzoek Burgerperspectieven (2017) Burgerperspectieven 2017-1. Sociaal Cultureel Planbureau (SCP)

The challenges of globalization

Globalization is not retreating. Although physical merchandise trade is not growing, trade in (digital) services is. Leveraging the network effects of digital platforms, more global players emerge. To ensure these global players do not arbitrage between different regulations, such as corporate taxes and data protection, we need to enforce global regulation. By imposing global regulation, we will have to move more sovereign power to global institutions. And this poses major challenges, for how do we get support for increased supranational corporation when more people are discontent with globalization? Although this might seem like a deadlock, it is not necessarily so.

There are two underlying reasons why a growing population group is discontented with globalization. As explained, the "Somewheres" are seeking to reclaim sovereignty from supranational institutions such as the EU. They feel that they did not prosper through globalization and that their (perceived) benefits did not outweigh the downsides. Plus, they feel like they have no control of the changes in their daily lives which are initiated by people far from their sphere of influence who do not comprehend their needs. To influence their disposition towards globalization, we need to address two challenges:

1. How we can better distribute and compensate the costs of globalization.
2. How we can give the population back more control on their daily lives.

The first challenge of globalization is a redistribution issue. This is similar to the discussion at the Dutch Transformation Forum 2016 about the inclusiveness of all population groups. Last year we argued that, to save technological advancement from itself, we need to invest in the groups who are not thriving in the changing society, to increase their resilience. If we don't, then they will democratically halt future advancement, which is detrimental for us all.[55] Our challenge with globalization is the same; we need to ensure that everyone in society shares in the benefits and especially the costs of globalization, for if we don't then those who feel discontented can democratically halt globalization. Companies as well as the government can play a role in increasing the support for globalization. As we described in last year's paper, companies can, amongst others:

55 Blom, Steffens, Brekelmans & Boschloo (2016) *Inclusiveness - in everyone's best interest.* The Boston Consulting Group

- Strive to use technology in a more inclusive manner
- Train employees also beyond their short-term interest
- Engage in the public debate

The second challenge of globalization addresses the influence that citizens have in political decision-making. There are two ways to confront this: either by bringing them closer to the decision-making, or by bringing the decision-making closer to them. Examples of the first are binding referenda or neighborhood meetings with the police. Examples for the latter are electing a mayor or a decentralized democracy, such as is exercised in Switzerland where much decision-making is done at canton or community level. This is a less explored option and we want to challenge you to think about it.

Historically, we have seen a gradual delegation of government responsibilities to higher governmental layers. This ensures a more effective delivery of public services. For example through joined garbage disposal at a regional level and defense (military) at a national level. Now with the creation of the European free market and a uniform currency, national responsibilities have moved up to the EU.

With every move up in governmental layer the decisions are made further away from the citizen's sphere of influence. However, especially since the past recession, people have started to question the desirability of the distance between them and decision-making. Nobody asked them if they approved of their tax money being used to bail out Greece. Nobody asked them if they wanted to help asylum seekers. These decisions were taken without their consent. And when the population did protest, it made no difference. Apparently, their opinion did not matter; they were left feeling marginalized.

There is a trade-off between having an efficient level of decision-making and a population's sense of marginalization, which is influenced by the degree to which governmental responsibilities influence the "Somewheres". The current dissatisfaction of many is a sign that it is time to rethink the efficient-marginalization trade-off of the optimal governmental layer for governmental responsibilities. It is possible that the optimal level of delegation is <u>not</u> the most efficient layer of delegation; potentially it will be delegated downward as a compensation for other, more important dossiers moving upward. Thus by delegating some governmental tasks to the citizen's sphere of influence, the government can increase support for the required further cross-border collaboration regarding supranational issues such as data protection and corporate taxes.

An example of the delegation of governmental responsibilities can be found in Switzerland. The Swiss political system is played out at three levels: federal, cantonal and the communal. Each has the authority to decide on certain matters, in accordance with the principle of subsidiarity: a decision is made at a higher level only when it is beyond the power of the lower level to do so. The federal constitution organizes foreign relations, national defense and customs. Cantons generally organize hospitals, universities and armed police forces. Communities organize public schools, water supply, and garbage collection. All three levels collect taxes to finance their affairs. However the levels of taxes vary between cantons and between communities.

Companies can help governments successfully delegate power. They have been motivating labor forces and creating self-steering teams for a long time. They understand that employees are more productive when they feel more responsible. Therefore companies have experimented with several management methodologies: Agile, Smart Simplicity, etc. A company will set out the overriding goal, while empowering their employees. Companies can help governments by sharing the knowledge they have gained and their best practices, helping them to set the direction and design good processes.

Globalization boosts our welfare. And to facilitate globalization we need supranational institutions. However we need to ensure that these institutions are supported by all. That is why governments – with business as a strong supporter and potentially an example in places – should rethink how to increase the inclusiveness of people in globalization.

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