The Fragmentation of the Global Economy and U.S.-Russia Relations

RAWI ABDELAL & IGOR MAKAROV

Working Group Paper 8
APRIL 2017

us-russiafuture.org

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Working Group on the Future of U.S.-Russia Relations

The Working Group on the Future of U.S.-Russia Relations convenes rising experts from leading American and Russian institutions to tackle the thorniest issues in the bilateral relationship. By engaging the latest generation of scholars in face-to-face discussion and debate, we aim to generate innovative analysis and policy recommendations that better reflect the common ground between the United States and Russia that is so often obscured by mistrust. We believe our unique, truly bilateral approach offers the best potential for breakthroughs in mutual understanding and reconciliation between our countries.

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Executive Summary

The development of globalization has not been one of steadily rising interconnectedness. Those who consider globalization to be an inevitable feature of our international landscape should bear in mind that two earlier waves of increasing interconnectedness foundered quickly with the onset of the twentieth century's world wars.

Since World War II, the rapid growth of information and communications technology, coupled with the increasing openness of the largest emerging economies, has fostered globalization. A commodities boom has led to greater interdependence among exporters and importers of natural resources; and the growth of credit and investment markets has created extensive global ties between creditors and debtors and between investors and investments.

But the foundations for the latest and greatest round of globalization are fragile. The current model of globalization requires that consumer nations (like the United States) buy more and more from producer nations (like China). This is unsustainable on both ends. In addition, globalization has forced restructuring of national economies in a way that increases aggregate growth by rationalizing the distribution of resources, but this comes at the expense of losses experienced by individuals, industrial sectors, and localities in many countries. As a result, income inequality has risen in almost every country in the world, and the groundswell of national populism reflects that.

The fragmentation of the world economy into more regionalized trading blocs will affect the United States and Russia differently. President Donald Trump has outlined a philosophy of "America First" that heralds a U.S. move toward protectionism and the fragmentation of the global economy. The likely consequences for the United States are dire: The United States is dependent on an increasingly skeptical world to finance its large current account deficits; far-flung production chains for goods made or designed in the United States might be disrupted in ways that will increase both costs and prices; and, ultimately, this withdrawal will accelerate the nation's long-term secular decline as a share of world output. All of this will mean less U.S. influence in the world (for better and for worse). While Russia has become more interconnected with global financial and commodities markets over the past twenty-five years, it resents that it was never fully integrated into Western political and economic circles. The Ukrainian crisis that began in 2014 has isolated the Russian Federation from the West, strengthening further its focus on developing the regional Eurasian Economic Union and on increasing trade ties with China and other Asian countries. Russia's economic growth remains highly dependent on commodity exports, which may make it less susceptible to the costs of reduced globalization but which will limit economic development for decades to come.

The prospects for U.S.-Russia economic cooperation in a deglobalizing world are limited while American and European sanctions are still in place. In theory, the White House could unilaterally cancel sanctions imposed after the annexation of Crimea, but Congress must lift those institutionalized in the Magnitsky Act of 2012. It is therefore likely that they will remain an irritant in the bilateral relationship for years to come. However, the Trump administration could decide to discontinue tightening the sanctions on the energy, defense, and banking sectors. Given that the effectiveness of sanctions erodes as markets adjust, this would gradually scale back the economic impact of the sanctions.

Introduction

Building a new era of globalization after World War II was an extraordinary achievement. Though it did not, to be sure, bring prosperity to everyone, it played an important role in pulling millions people out of poverty and raising living standards. Though the world is still full of conflicts, global interconnectedness holds them relatively localized; and, in general, the world now is more peaceful than at any period in history.

Globalization especially accelerated in the twenty-first century fostered by the rapid growth and increasing openness of the largest emerging economies. National economies became unprecedentedly interconnected. Commodity boom increased interdependence between exporters and importers of natural resources. Rising global imbalances illustrated stronger ties between creditors and debtors.

However, the base for this interconnectedness was fragile. Structural deceleration of economic growth in emerging economies, macroeconomic crisis in the developed world, a fall in oil prices, and narrowing global imbalances—all these factors decreased the level of economic interdependence. Trade-to-GDP ratio has decreased for the past years, and the world economy is close to entering the vicious circle of slowing trade and slowing GDP. International capital movement collapsed during the world financial crisis and hasn't recovered. The international migration flows have strengthened for the past years, but they are far from sustainable and are expected to decrease in the near future. Protectionism and populism have spread over both developed and developing worlds.

The world economy does not yet show signs of fragmentation into national territories. For now the trend seems increasingly toward regional systems that are compartmentalized. International trade and value chains become increasingly regionalized, which is logically followed by the regionalization of regulations. For instance, the WTO, the key institution of the multilateral trade system, gradually finds its dominant positions being supplemented by regional trade blocks. After the Great Recession the global world turns into the world of regions that allows drawing parallels with the World War I era, which had very similar effects a century ago.

The world economy does not yet show signs of fragmentation into national territories. For now the trend seems increasingly toward regional systems that are compartmentalized.

However, unlike the world of the early twentieth century, the current world has another major source of interconnectedness in addition to trade and finance. It is information, exchange in which grows exponentially regardless of the macroeconomic situation. Digitalization of economy transforms many important businesses and lets them work in an environment slightly dependent on national borders. In a fragmenting world, it is information that plays the role of umbrella, covering increasingly isolated regions and keeping them together.

Dramatic changes in the course of globalization affect all countries, including the United States and Russia. For the United States they coincide with and are partly caused by the end of an era of American leadership in the global economy. While President Barack Obama's administration made an attempt to derive benefits from new fragmentation through the launch of Trans-Pacific and Transatlantic partnerships, President Trump chose to strengthen preexisting trends toward fragmentation and protectionism.

Russia has never been able to derive as many benefits from globalization as the United States. However, the rollback of globalization brings new challenges associated with Russia's isolation from major interregional ties. Russia's main response is the development of Eurasian integration.

In the fragmented world, the impulse for any breakthroughs in U.S.-Russia relations can't be strong.

In the fragmented world, the impulse for any breakthroughs in U.S.-Russia relations can't be strong. The countries' main focus may be directed toward coping with global problems, terrorism in particular. In an economic sphere, any significant progress is impossible because of sanctions. In theory, the two countries may move toward a grand bargain on the new world order wherein each nation's core interests are respected, particularly insofar as they do not overlap with the others'. However, political struggle amongst American elites and intense pressure placed on President Trump by liberals make such a deal complicated.

What the two countries are able to do together is to maintain the sustainability of the world economic order that nowadays faces one of the strongest transformations in modern history. Fragmenting of the world economy is hard to reverse, but both Russia and the United States might be able to play a coordinated and positive role in making sure that the regional systems that emerge are open to one another, as opposed to compartmentalized.

The Second Great Era of Globalization

We define globalization as the process of integration of national economies and the increase in international exchange across country borders, which, in turn, leads to growing interconnectedness between countries. The first great era of globalization understood in this manner was between roughly 1870 and precisely 1914, when goods, services, labor, and capital flowed across political borders with ever-increasing ease. Markets became global, rather than bounded by the territories of states. That era of globalization collapsed amidst the political discord and violence of the First World War. Although some political leaders sought to rebuild that order after the war, by the end of the 1920s the system was fraying. Contagious financial crises, currency and capital controls, powerful nationalist and populist movements on both the right and the left, and protectionism undermined efforts to reintegrate the national markets of the world. By the end of the Second World War global market integration—as both a fact and as a political agenda—had been destroyed.

The first decades of the postwar period were marked by the geopolitical confrontation between the United States and the Soviet Union. European integration began to lay some institutional foundations for increasing market integration. The United States made considerable progress in promoting free trade, though financial markets remained constrained by national borders. The Soviet Union, China, and India, among many other states, remained largely closed off to efforts to remake a more open world economy.

During the 1980s the United States and Europe initiated a process of market integration that increasingly included capital as a factor of production and more nations whose governments chose to embrace market integration as essential to their development strategies. East Asia in particular promoted the trend. And the transformation of the Chinese model began to fundamentally alter the system. With the collapse of the Soviet Union and the opening up of India in 1991, a second great era of globalization began to take shape. Its comprehensiveness was, by the end of the 1990s, impressive.

Although the gains from global market integration were distributed unevenly both within and across societies, the achievements of this era were considerable. Millions of people were pulled out of poverty. Opportunities for development were created by access to large markets. Global interconnectedness increased the costs of conflicts for all the actors and thus helped to keep conflicts relatively localized.

Commodity markets also experienced a long boom as output growth, rising incomes, and infrastructure investment, particularly in Asia, led to demand for fossil fuels, minerals, metals, fertilizers, and agricultural products. These commodity flows also increased the connectedness of the global economy, as the fates of importers and exporters were increasingly intertwined. Firms and governments in some commodity-importing countries sought to diversify from their dependence on fossil fuels toward alternate sources of energy, as well as from conventional sources toward those that were more unconventional, such as those long buried beneath theretofore impenetrable shale rock. Commodity-exporting countries meanwhile accumulated massive amounts of capital in sovereign wealth funds and central bank reserve assets after years of growing current-account surpluses.

The End of an Era

The second era of globalization was built on foundations that seemed increasingly fragile. An ongoing transition of great powers (the rise of China and the relative decline of the United States) presented new challenges to global governance. And the prospect of a slower-growing world economy is likely to put greater political strain on the system.

Two divisions grew starker. The first was the divide between nations with relatively low household savings rates, high rates of household consumption, and large current-account deficits, the United States foremost among them; and those nations with high savings rates, modest domestic consumption, and current-account surpluses, particularly China and the commodities exporters. Although the world economy is never in balance, these so-called "global imbalances" reached record highs. (See Figure 1.)

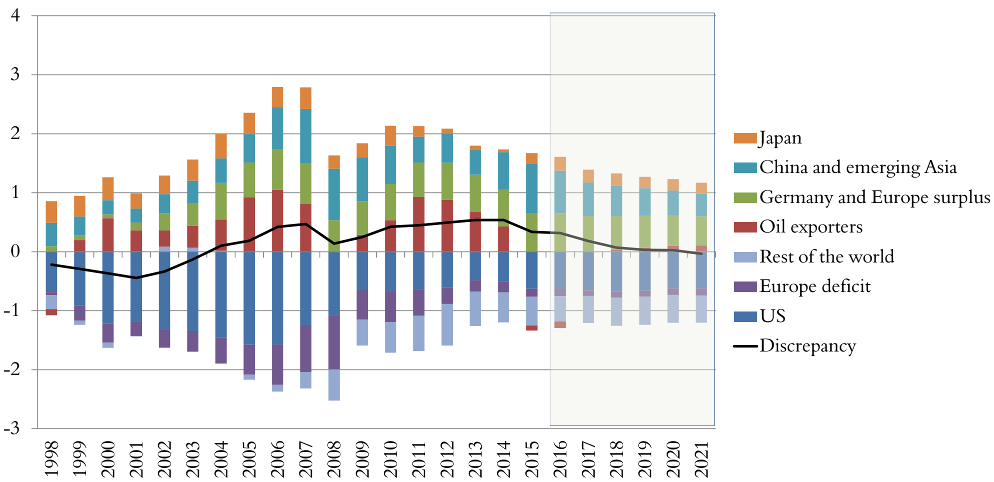

Figure 1. Global current-account imbalances as a percentage of global GDP in 1998–2021.
Source: *IMF World Economic Outlook*, October 2016.

The second divide was between the haves and the have-nots. Within nations, income inequality was growing more pronounced. Except for a handful of nations in northern Europe—particularly Germany and Denmark—almost every nation in the world experienced rising income inequality as measured by Gini coefficients or the shares of national income accruing to, for example, the top 1 percent of income earners. Populist movements on both the left and the right began to focus their attention on the unevenness of the gains of globalization. Across nations, too, access to functioning markets and political stability, even peace itself, led to record flows of migrants and refugees around the world, a process that further pushed national politics on the developed world toward skepticism of the benefits of the global order.

The organization of power in the world was, meanwhile, continuing its transformation, as the relative decline of the United States was matched by the reemergence of China as a great power. At the time of this writing, the United States and China each accounted for roughly equal shares of total world output. Insofar as the first great era of globalization was built around the United Kingdom, and the second great era on the predominance of the United States, a more multipolar world order led to widespread beliefs that the fundamental rules of the system might need to be rewritten in order to reflect a different distribution of power.

Emerging markets are experiencing, moreover, a deceleration of economic growth as the underlying fundamentals of the system continue to change. The economic model that delivered rapid output growth in China has given way to a new agenda outlined by the Chinese government: Rather than rely on foreign households to drive export-driven growth, China needs, over the next decade or so, to "rebalance" toward domestic household consumption. This transition will be accompanied by growth of only 5 or 6 percent, rather than the nearly 10 percent to which the world—and Chinese households—had grown accustomed. The Chinese slowdown, combined with structural oversupply in commodities markets and an ongoing macroeconomic crisis in Europe, has changed the macroeconomic environment for other emerging markets. Among the economies of Brazil, Russia, India, China, and South Africa (BRICS), India alone enjoys robust rates of economic growth now. (See Figure 2.)

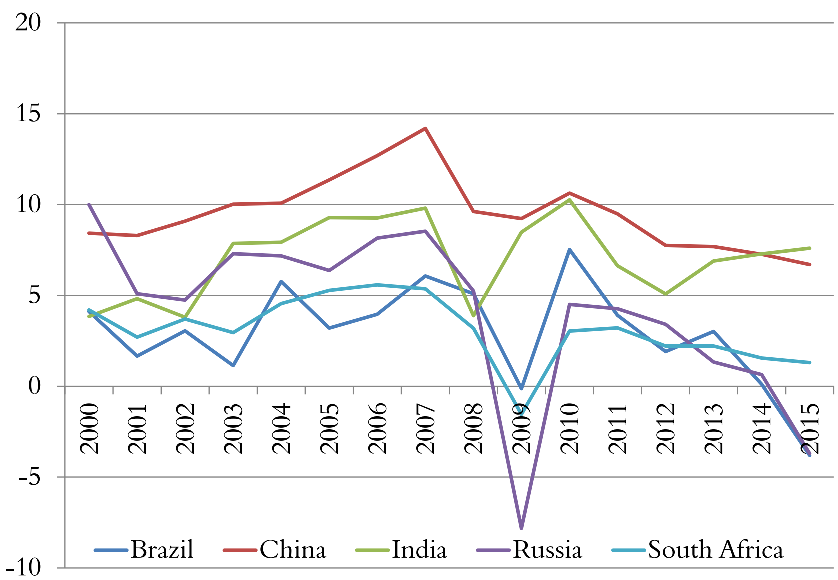

Figure 2. Rates of GDP growth in BRICS countries in 2000–15, percent.
Source: World Development Indicators.

This deceleration of economic growth in BRICS countries is likely long-term. All of them (except, probably, India) have reached the limits of the efficiency of their economic models. Further rapid extensive development on the base of a cheap labor force or abundant natural resources is no longer possible. The middle-income trap in which BRICS countries are caught requires the transition to new models of economic growth, based on services and innovations. However, such transition is complicated given institutional limitations.

The decline in oil prices starting in 2014 undermined the influence of the Persian Gulf states and other oil exporters. In response to the drop in budget revenues, some of them had to spend part of their sovereign wealth funds. Moreover, the development of oil reserves in new countries, rapid construction of liquefied natural gas (LNG) infrastructure, and the "greening" of energy mix, together with falling oil prices, dramatically decreased oil and gas interdependence. Given that technological trends as well as the demand for energy independence and for green development are long-term, it is unlikely that oil will ever be back as one of the major factors of global interconnectedness.

As a result of an ongoing macroeconomic crisis in developed countries, a decline in oil prices, and the internal rebalancing of China, global imbalances have narrowed substantially since the Great Recession. (See Figure 1.) It is likely that they will continue to narrow in the future. Narrowing global imbalances have ambivalent effects on our era of globalization. On the one hand, they would make the global economy less vulnerable to economic crises, and on the other hand, they would make the global economy less interconnected.

We can see signs of weakness in the very markets that have been emblematic of our era of globalization.

Given that technological trends as well as the demand for energy independence and for green development are long-term, it is unlikely that oil will ever be back as one of the major factors of global interconnectedness.

Trade in Goods and Services

The growth of trade in goods and services decelerated in real terms every year since 2012 and in nominal terms even decreased in absolute values in 2014 and 2015 (See Figure 3.)[1] In 2012–15, global trade grew more slowly than world output.

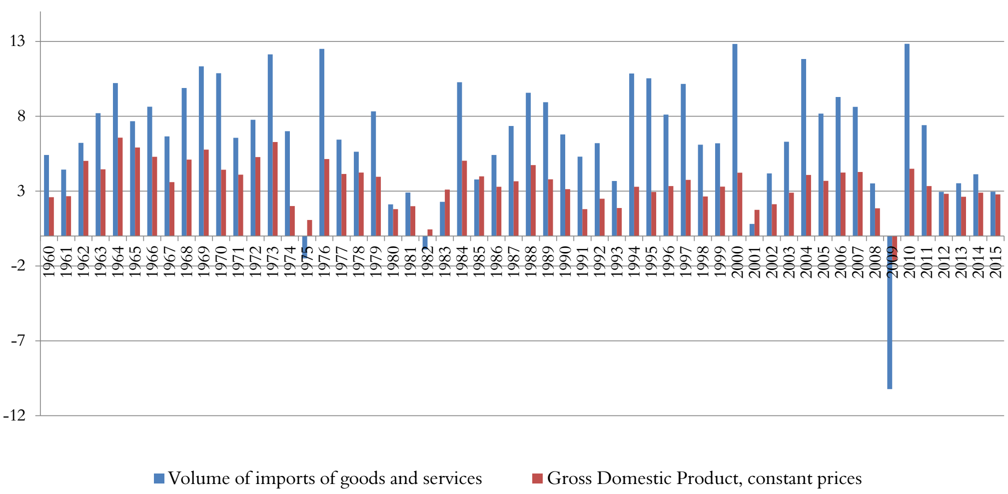

Figure 3. Rates of growth in GDP and world imports in 1980–2015, percent.
Source: IMF Data.

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1 International Monetary Fund, 2016. World Economic Outlook, International Monetary Fund.

The structural slowdown of international trade for structural reasons is aggravated by the rise of protectionism. While tariffs are effectively addressed by the World Trade Organization and continue to decrease, targeted protectionist measures (temporary trade barriers, anti-dumping, and so on) have spread widely for the past years. In 2010–15, 791 new nontariff barriers appeared annually on average—that is, more than ever in history.[2] Most of these measures are not as visible as conventional tariff barriers, but they affect international trade significantly. They may be called "micro-protectionism" and characterized as "perhaps individually small but collectively deadly."[3] (See Figure 4.)

Protectionist sentiment has grown in precisely those nations of the West in which rising income inequality accompanied global market integration.

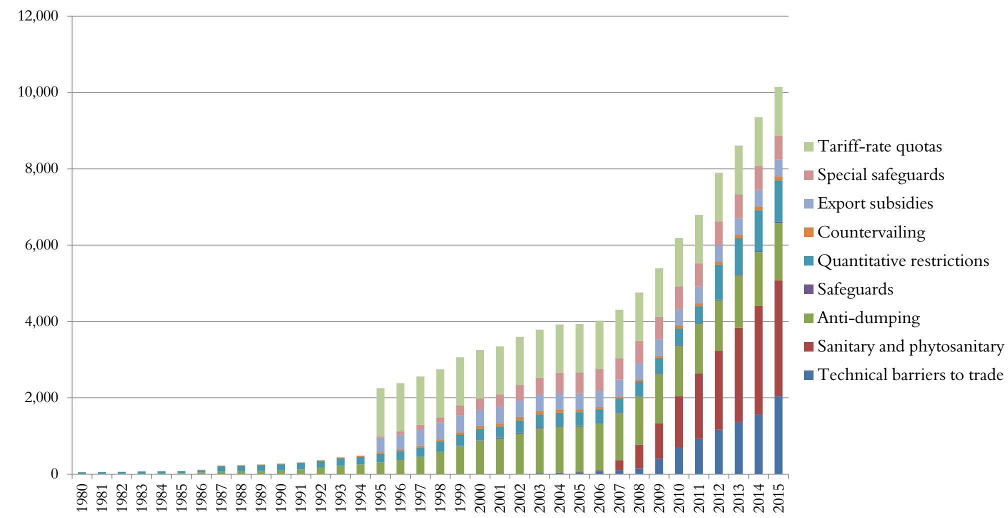

Figure 4. Number of nontariff barriers in force in 1980–2015.
Source: World Trade Organization, Integrated Trade Intelligence Portal (I-TIP).

Protectionist sentiment has grown in precisely those nations of the West in which rising income inequality accompanied global market integration. The causes of this rising income inequality are varied and difficult to quantify with precision. Automation has undermined the ability of unskilled workers to compete in labor markets. Increasing returns to talent and education have led to pressures for wage dispersion. And the essential logic of international trade and cross-border capital movement is pressure for wage equalization of similarly skilled workers across country borders.

Although globalization is thus only one cause among many for rising income inequality, it has proven politically the most vulnerable. Populist politicians on the right and the left have naturally shied away from blaming robots or poor study habits for the plight of the working class in the developed world. But identifying the practices of elites, corporations, and foreigners as culprits has been more straightforward.

In developed countries, during the era of easy credit and growing household leverage during the 1990s and 2000s, households with stagnating incomes were able to maintain their standards of living with debt and the extraction of equity from their residential assets. The fundamental stagnation of the average standard of living was thus masked for a time.

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[2] WTO, Integrated Trade Intelligence Portal (I-TIP).

[3] G. Hufbauer and E. Jung, *Why Has Trade Stopped Growing? Not Much Liberalization and Lots of Micro-Protection.* Peterson Institute for International Economics, April 20, 2016.

The end of that era of leverage has brought these simmering resentments to the forefront of national political debates. The Brexit was a spectacular indicator of the turning tide. The popularity of President Donald Trump's antiglobalization rhetoric—matched on the left by that of Senator Bernie Sanders of Vermont—is another.

The rise of protectionism fueled by populism is dangerous for the global economy. Its negative effect is especially strong now when international trade decelerates for structural reasons. The crucial challenge for the global economy now is that the virtuous circle of growing trade and GDP that has pushed economic development forward for the last decades may be replaced by the vicious circle of decelerating trade and slower economic growth.

Flows of Capital

While international trade after the global financial crisis stagnated rather than shrank, international capital movements demonstrated full-scale collapse. According to McKinsey calculations based on IMF data, cross-border capital flows as a percentage of global GDP fell from its peak level of 20.7 percent in 2007 to 4.6 percent in 2008. After partial recovery in 2010, they continued to decrease and achieved a record-low 2.6 percent in 2015. (See Figure 5.)

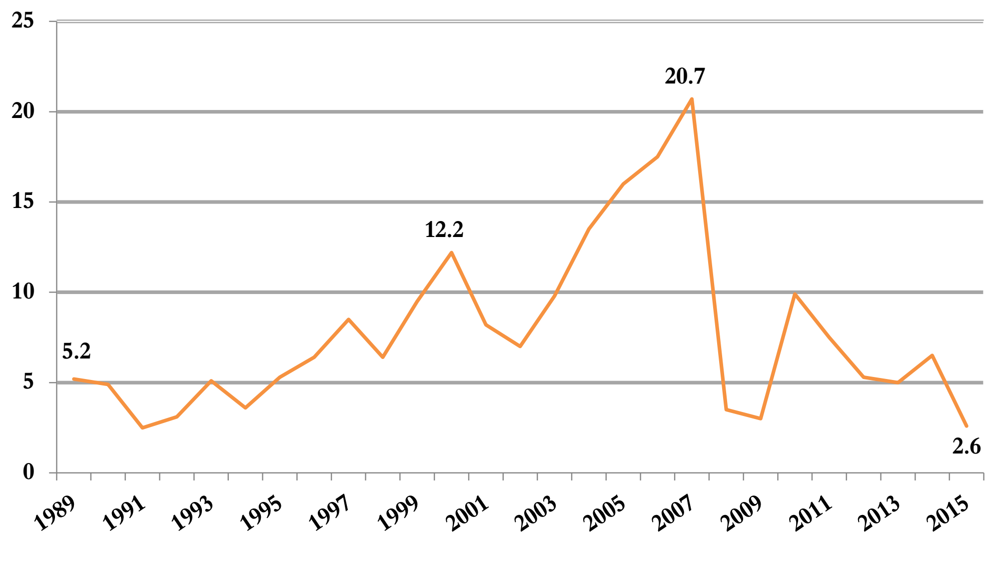

Figure 5. Global cross-border capital inflows in 1989–2015 as a percentage of global GDP.
Source: McKinsey Global Institute.

About three-quarters of capital movement decline in 2007–15 can be explained by the evaporation of cross-border bank lending.[4] To a large extent, its drop is a result of tighter regulation aiming to make the global banking system more sustainable. The Great

[4] S. Mallaby, *The Retrenchment in Cross-border Capital Flows and Trade May Be Less Dire Than It Seems*. McKinsey Global Institute. Finance & Development, December 2016.

Recession showed the dangers of financial liberalization and deregulation of the banking sector. Greater involvement of the state in the banking sector may be considered a step toward a more manageable global financial system. However, whether it is true or not, current trends result in decreasing interdependence between countries and supplement the similar tendency in the dynamics of international trade flows.

While international banking collapsed, the dynamics of foreign direct investment (FDI) is more complicated. They fell in absolute terms in 2013–14 and increased in 2015 but are expected to fall again in 2016. Profitability of multinational enterprises (MNEs) shows a downward trend since 2010.[5] The decrease in FDI flows was one of the factors contributing to narrowing global imbalances. Similar to the decline in bank lending, it may be a positive sign from the perspective of long-term sustainability of the global economic system. However, it is also a sign of financial globalization slowdown or even decline.

International Migration

Contrary to international trade and international capital movement, international migration shows the upward trend. Nevertheless, one can expect that this trend can cease in the near future. European migration policy can hardly be considered sustainable—that is well reflected by the term "European migration crisis," often used to describe the current situation even in mainstream media and in political debates. Uncontrolled migration leads to some obvious dangers, and in addition public discontent is mobilized and expanded by populist political forces. Some use radical nationalist and xenophobic rhetoric, but most of them simply rely on "blue-collar" workers' concerns about jobs and follow the easy way to blame immigrants for various social problems.

As a result, most European countries are on the threshold of revision of their migration policies toward creating more entry barriers. The new U.S. presidential administration is likely to do the same. Given that the two largest economies receiving immigrants will gradually close off migration inflows, international migration may consequently decline in the near future.

5 United Nations Conference on Trade and Development (UNCTAD), 2016. World Investment Report 2016—Investor nationality: Policy challenges, United Nations Publication.

A Fragmenting World Economy

The world economy does not yet show signs of fragmentation into national territories. For now, the trend seems increasingly toward regional systems that are compartmentalized.

In part, this process has resulted from interregional income convergence. On average, living standards in East Asia are still much lower than those in developed countries. However, in the eastern provinces of China, where major industrial centers are located, labor costs are already higher than in Mexico or eastern Europe. This convergence of incomes between regions narrows opportunities for interregional exchange based on comparative advantage. European imports from the Asian continent grew by 212 percent in 2001–8. In 2015 European imports were smaller than in 2008. Imports from Asia to North America grew by 101 percent in 2001–8 and since that time have increased by only 23 percent.[6]

Inequality grew during the past thirty years both within regions and within countries.

Interregional income convergence goes in parallel with intraregional divergence. Inequality grew during the past thirty years both within regions and within countries. Outstanding success in economic performance in China widens the gap between this country and neighbors, like Bangladesh, Cambodia, Myanmar, and Laos. China itself became more diverse in terms of personal incomes, combining rich eastern provinces and poor regions of the central and western parts of the country. This growing diversity of income levels provided a basis for regionalization and nationalization of value chains. As a result, China's participation in international value chains now is smaller than at the end of the 2000s.[7] Asian value chains are oriented now not only to Western countries but also, to a growing extent, to Asian consumers. As a result, intraregional trade in Asia has begun to dominate. In 2001, 54 percent of Asian exports were intraregional, and in 2015 this share was 62 percent. During the same period, the share of exports to Europe and North America decreased from 23 to 18 percent and from 29 to 19 percent respectively.[8]

The regionalization of value chains is likely in North America and Europe as well. Outsourcing industries to China is not a beneficial strategy anymore. At the same time, cheap energy as a result of the shale gas revolution and the growing immigration let Barack Obama declare a "reindustrialization strategy" and launch a "Buy American" movement. The outcomes of these initiatives are limited to the moment, but global trends play in favor of them. Donald Trump's administration is likely to make even larger efforts to foster reindustrialization.

6 COMTRADE data.

7 International Monetary Fund, 2016. World Economic Outlook, International Monetary Fund.

8 UNCTADstat.

European plans for reindustrialization and regionalization of value chains are less institutionalized. However, divergence of economic performance across member states during and after the Great Recession and the huge inflow of immigrants who can become the cheap labor force in the future make Europe a more self-sufficient region than before. Growing current-account imbalances between Germany and other European countries are unlikely to be sustainable but strengthen intraregional ties.

Long-term technological trends are also favorable for further regionalization and localization. Technological innovations like 3D printing and automation decrease dependence of industrial processes on a cheap labor force and would contribute to localization of industries and compression of value chains.

Long-term technological trends are also favorable for further regionalization and localization.

In the energy sector, the development of renewables means a shift to local sources of energy from internationally traded ones. Probably, in the world where renewables will dominate in an energy mix, electricity will be traded much more intensively than it is now. However, electricity markets would be regional unlike the markets of fossil fuels, which are global.

Over the past decades, impressive progress in long-distance transportation has been achieved leading to a dramatic drop in transport costs. In 2015, shipment of flat-screen TVs from Shanghai to Rotterdam on board Maersk ships cost $2, a pair of sport shoes 11 cents, a tablet computer 5 cents, a T-shirt 4 cents.[9] Such small costs show that transport cost–related relative attractiveness of goods shipped from the other continents over that of the local goods has reached its limits. At the same time, more attention will be paid to the time of transit (it is still measured in dozens of days for transcontinental deliveries) and environmental impacts of long-distance shipping. Local or regional goods are more attractive in terms of these parameters.

Regionalization of international trade is logically followed by regionalization of its regulation. It started in the early 2000s when negotiations shifted gradually from the multilateral to the regional level where their main focus was directed at regional and preferential trade agreements. While the WTO, the core of the multilateral trade system, faced the deep crisis of the Doha round, it was these agreements that contributed the most to the opening of markets and lifting trade barriers in the 2000s. Moreover, many regional and preferential trade agreements expanded the area of regulation to such spheres as investment, services, intellectual property rights, and transparency.

Regional and preferential trade agreements have become the first steps to megaregional trade initiatives, primarily the Trans-Pacific Partnership (TPP) and Transatlantic Trade and Investment Partnership (TTIP). These initiatives were the response of the United States to both the WTO crisis and the regionalization trend and aimed at strengthening U.S. positions in a regionalized world.

On the one hand, TPP and TTIP might have become bridges between the United States and Asia and Europe in order to get United States involved in both of them. On the other hand, these initiatives should have created the space of common standards within Asia

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9 https://www.maerskline.com/da-dk/about/facts-figures.

Pacific and Atlantic megaregional blocs. Various standards concerning labor, environment, protection of investment, government procurement, state-owned enterprises, exchange rate practices, and intellectual property rights that were not fully covered by the WTO regime were included in the texts of these new agreements.[10]

For the moment, it is most likely that this U.S. strategy has failed for both external and internal reasons. TTIP still may be signed though it faces huge pressure from a number of European countries. As for TPP, under Donald Trump's administration U.S. participation in this agreement is nearly impossible. In terms of trade relations, it is therefore unlikely that the United States will be the part of the Asia-Pacific or the Atlantic region. Moreover, the new president's proposals to withdraw from NAFTA would dramatically change the current system of economic collaboration even within North America, with highly uncertain consequences.

[10] G. C. Hufbauer and C. Cimino-Isaacs, 2015. "How Will TPP and TTIP Change the WTO System?" *J. Int. Econ. Law* 18, 679–96; M. Griffith, R. Steinberg, and J. Zysman, 2015. "Great Power Politics in a Global Economy : Origins and Consequences of the TPP and TTIP." Presented at a conference "Unpacking the Transatlantic Trade and Investment Partnership (TTIP) Negotiations," Université Libre de Bruxelles (ULB), October 17.

New Source of Interconnectedness

Similarly to the way World War I divided the globalized world of the early twentieth century into regional systems, the Great Recession made the same in the early twenty-first century. Barack Obama's administration, by means of megaregional initiatives, made an attempt to transform a world of the regions into a world of megaregional blocks with a dominating role assumed by the United States. This attempt failed.

A new major source of interconnectedness appeared—information.

However, the regionalization of the global economy now differs a lot from that after World War I. A new major source of interconnectedness appeared—information. The volume of interregional exchange in data grew by forty-five times in 2005–14 and this dynamic was not affected by the Great Recession.[11] The global economy is being rapidly digitized. The Internet now not only makes possible further time and space compression but also creates a new environment for corporate activities and changes the basic principles of their operation.

Probably the most important change is the rise of virtual platforms. This business model suggests that instead of producing goods and services, a company provides a platform where producers and consumers may exchange values. Platforms as a business model have always existed (for instance, in the form of newspaper ads, local markets, and shopping malls), but it is information technologies that gave them the new impetus. Virtual platforms have made it much easier to match producers and consumers in a multisided marketplace. They have also decreased the costs of entry to the market, creating opportunities for small companies and individuals from all over the world to participate in international trade. This has made platform businesses highly profitable, as they now may gain from economies of scale.

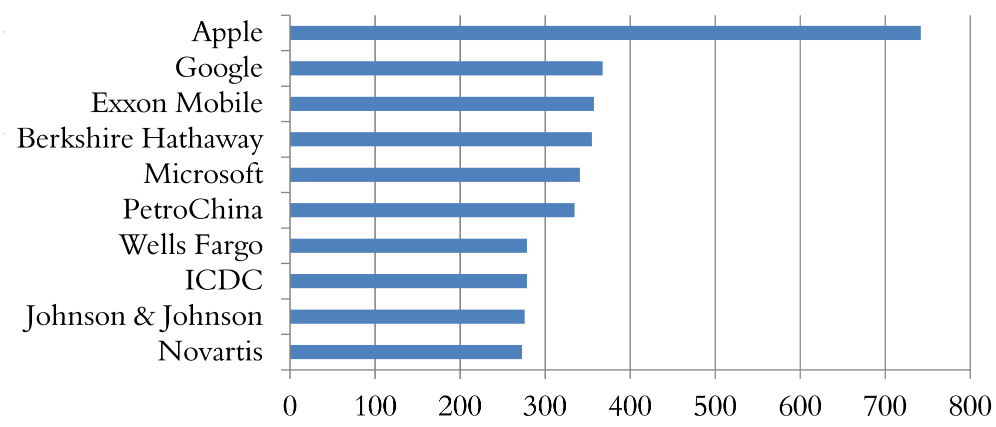

Figure 6. Market value of the world's biggest companies in 2015, in billions of dollars.
Source: *Forbes* 2000.

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[11] McKinsey Global Institute, 2016. *Digital Globalization: The New Era of Global Flows*.

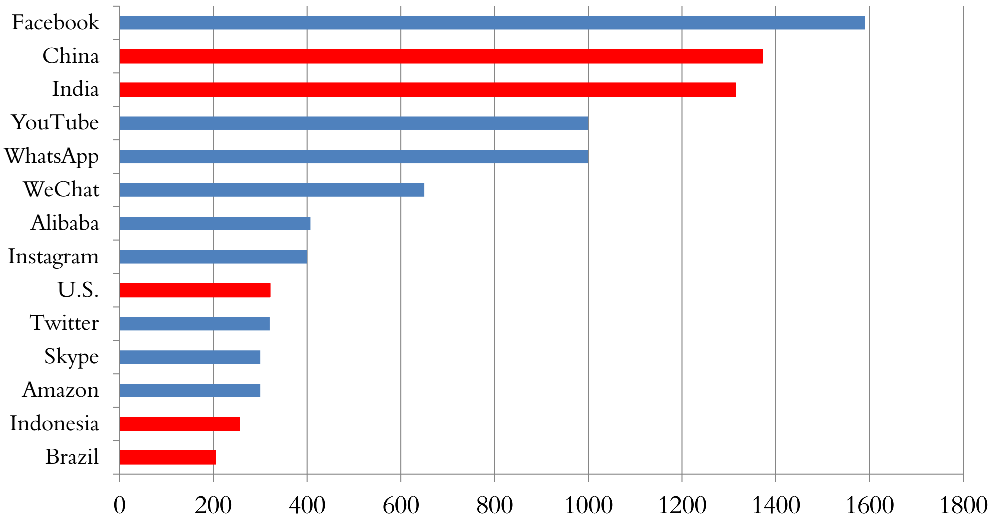

Figure 7. Audience of leading virtual platform in Q4 2015 and population of biggest countries in 2015, in millions of people. Source: McKinsey Global Institute, *Digital Globalization: The New Era of Global Flows*, 2016.

Virtual platforms have already significantly changed a lot of businesses in which information plays a crucial role: IT, media, tourism, and consulting. It is no coincidence that these spheres have been the least resilient to the fall of economic activities for the past years and have continued to expand.[12] Moreover, the real dynamics of these businesses are likely to be better than reflected in cross-national statistics, as virtual platforms operate beyond national borders and their activity is hard to account in a proper way. For example, the growing share of Airbnb at the market of tourist accommodation makes accounting for international tourist flows much more complicated. In the future, platform-type businesses may become dominant in other markets, including such important ones as venture finance, banking, transportation, education, and even health care.[13]

While traditional types of interconnectedness—international trade, movement of capital—are weakening in the near future, it is information that plays a role of an umbrella that covers increasingly isolated regions and keeps them together.

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[12] International Monetary Fund, 2016. World Economic Outlook, International Monetary Fund.

[13] S. P. Choudary, M. W. Van Alstyne, and G. G. Parker, 2016. *Platform Revolution: How Networked Markets Are Transforming the Economy and How to Make Them Work for You*. W. W. Norton & Company.

Implications for U.S.-Russia Relations

The end of the second great era of globalization and fragmentation of the global economy will likely produce different implications for the United States and Russia as individual nations, and the effects on their relations with each other are uncertain.

For the United States, the end of this era of globalization coincides with—and is caused in part by—the deliberate end of an era of a particular kind of American leadership in the global economy.

For the United States, the end of this era of globalization coincides with—and is caused in part by—the deliberate end of an era of a particular kind of American leadership in the global economy.[14] The Trump administration's explicit commitment to bilateralism and "America First," as well as its rejection of multilateralism and the belief that an American-led global economy benefits the United States most of all, will hasten preexisting trends toward fragmentation and protectionism. This approach represents a divide between American political and business elites, on the one hand, and the majority of citizens, on the other. Moreover, the waning U.S. commitment to a global order opens the possibility for either more robust Chinese leadership in the system as a whole or the development of regional systems organized around great powers, Russia among them.

The meaning of the end of this era is more ambivalent within Russia. The Soviet Union had, of course, isolated itself from the emergent global order on principle, while Russia during the 1990s explored seriously the possibility of its joining the U.S.-led system. Even in the 2000s, when Russia's contradictions with the West began to accumulate, its openness in terms of trade and finance increased. In 2007, the roadmap of Russia's accession to OECD was approved. In 2012, Russia joined WTO. The year 2013 was that of Russian presidency in G20, where enhancing international trade was one of the key elements of proposed agenda.

However, deeper integration into the world system hasn't brought much prosperity to Russia. Its participation in the world economy has remained one-sided: The country exported simultaneously natural resources, capital (investment outflow in 2015 alone achieved $57 billion), and brains (though the net outflow of qualified labor is now much smaller than in the 1990s, it is still positive).[15] It should not be surprising that most Russians are suspicious about globalization.

For the past decade and a half the Russian government has increasingly resented and rejected the collection of rules and practices of the existing world system. Many Russians came to recognize this system not as "Globalist," but Western, and the expansion of Western institutions—in particular, NATO and the EU—toward Russian borders as encroachment and encirclement. Eventually the result was confrontation.

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[14] R. Abdelal and A. Segal, 2007. "Has Globalization Passed Its Peak?" *Foreign Affairs*. 86, 103–14.

[15] L. Grigoryev, 2012, "Russia's Economy: After Transformation, before Modernization." Valdai Discussion Club Analytical Report.

Still, Russia benefited from some of the opportunities presented by such a system. The Russian economy began the 1990s dependent on hydrocarbons for growth and ended the 2000s even more so. Without the commodity boom, Russian political elites would have found it more challenging to rebuild the authority of the Russian state within its territory and, eventually, to reassert its influence in the world. During these twenty-five post-Soviet years, the Russian economy achieved very limited success in developing any competitive advantages except the abundance in natural resources and therefore failed to adapt to an era of globalization.

And it is not clear that the Russian economy is much better suited to adapt to an era of fragmentation and regionalization that will bring new challenges. The largest of them is the risk of isolation from the most important intraregional ties. The Ukrainian crisis pushed Russia away from Europe, which had been Russia's largest economic and political partner for the previous decades. Only in 2012 did Russia start its belated movement toward Asia, with the purpose to become part of the "Asian economic region" and to get involved into Asian intraregional trade flows and value chains under its "turn to the East" policy. This movement holds promise but began from a very low base.[16] The Eurasian integration project in the form of the Eurasian Economic Union (EAEU) is an important part of Russian foreign policy, but its economic meaning is limited as the share of EAEU countries in Russia's trade turnover is less than 10 percent.

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In a search of more ambitious projects, Russia in cooperation with China has launched a co-development initiative in Greater Eurasia. It is based on coordination of the Eurasian Economic Union and the Silk Road Economic Belt and is aimed at creating a new center of economic growth in the region as a result of capital attraction and investment in infrastructure. It is important that both Russia and China consider this project as open to other countries—not only Kazakhstan and Central Asia but also Iran; Pakistan; India; South Caucasian countries; Mongolia; ASEAN states; probably South Korea, Japan, and Turkey; and, finally, even Europe. At the moment, these ambitious plans are supported by declarations rather than by real actions. However, negotiations of the EAEU with ASEAN countries and India on free trade zones and the launch of negotiations with China on comprehensive trade and investment cooperation agreement are good first steps. The accession of India and Pakistan to the Shanghai Cooperation Organization, which probably would be followed by Iran's entry also, plays in favor of Russia's and China's plans.

16 I. Makarov, S. Karaganov, O. Barabanov, T. Bordachev, E. Kanaev, V. Larin, and V. Ryzhkov, 2014. "Toward the Great Ocean 2, or Russia's Breakthrough to Asia," Valdai Club Report; T. Bordachev, S. Karaganov, O. Barabanov, A. Bezborodov, A. Kazakova, A. Likhacheva, A. Lukin, I. Makarov, A. Pyatachkova, A. Skriba, A. Sokolova, D. Suslov, and I. Timofeev, 2016. "Toward the Great Ocean 4: Turn to the East: Preliminary Results and New Objectives, Valdai Club Report.

The Cost of Sanctions

Regardless of the resulting effect on the Russian economy, sanctions will weaken dramatically the existing ties between Russia and the West, especially in the areas of banking, project finance, and technologies.

Sanctions imposed by the West (and by the United States in particular) against Russia may be divided into five major groups: (1) technological sanctions in the oil and gas sector; (2) financial sanctions against Russian oil and gas companies and the largest banks; (3) sanctions against the defense industry; (4) sanctions against companies operating in Crimea; and (5) sanctions on individuals. In response, Russia introduced counter-sanctions, first of all banning imports of food from Western countries.

The slowdown of the Russian economy started in 2011, long before the implementation of sanctions. It was caused by structural factors: In general, the model of economic growth Russia based on resource production and exports stopped working. Sanctions strengthened the negative trends in economic dynamics, but it is difficult to separate their effect from that of a structural slowdown and falling oil prices. As a result, estimates of sanctions-related damage vary from less than 1 to 8–10 percent of Russian GDP depending on assumptions, the range of consequences covered by a model, and time horizon.[17]

The first shock from the sanctions has been overcome. Oil and gas companies revised their investment policies, gained state support, and sold some assets. The government and Central Bank succeeded in avoiding the destabilization of the banking system and in maintaining inflation at a relatively low level. However, the price for this was the increasing interest rates that put additional pressure on business activity, dramatic cuts in budget expenses, and the freezing of pension funds. Problems therefore were not solved but just transferred to the future. Slowing of technology transfer and expensive credits as a result of sanctions will also decrease the efficiency of production in a few years rather than now.

At the same time, long-term effects are easier to mitigate. Whether this will be done depends on the efficiency of import-substitution programs that were launched in some sectors (oil and gas, military, food, etc.) and the availability of the new sources of finance (primarily from Asian markets).

Regardless of the resulting effect on the Russian economy, sanctions will weaken dramatically the existing ties between Russia and the West, especially in the areas of banking, project finance, and technologies. Ambitious joint projects in the energy sector were discontinued. Trade between Russia and the United States has fallen more than twice

[17] International Monetary Fund, Russian Federation: Staff Report for the 2015 Article IV Consultation, August 2015; E. Gurvich and I. Prilepskiy, "The Impact of Financial Sanctions on the Russian Economy." Russian Journal of Economics, Volume 1, Issue 4, December 2015, 359–85; K. Kholodilin and A. NetŠunajev, "Crimea and Punishment: The Impact of Sanctions on Russian and European Economies." Discussion Papers, April 11, 2016; R. Nelson, "U.S. Sanctions and Russia's Economy." CRS Report, 7-5700, February 17, 2017.

for the last three years. So did FDI: U.S. investment in Russia decreased from $20.8 billion in 2009 to $9.2 billion in 2015. Russian investment in the United States for the same period fell from $8.4 billion to $4.5 billion.[18] Only part of these trends is explained by sanctions themselves; others are a reflection of general economic situation in both countries. In any event, U.S.-Russia economic relations demonstrate now the worst dynamics seen in the past twenty-five years.

[18] R. Nelson, "U.S. Sanctions and Russia's Economy." CRS Report, 7-5700, February 17, 2017.

Conclusions

Although it is difficult to predict the development of U.S.-Russia relations under the new U.S. presidential administration, the different ways in which the two countries chose to react to the challenges of globalization leave limited space for their cooperation. At the same time, Donald Trump's decision to withdraw the United States from the TPP project would narrow the space of competition between the two countries. Though TPP did not suggest any serious barriers for Russia's current exports, it could have complicated the diversification of the Russian economy and expansion of some promising activities oriented at the exports to the APR, for example Far Eastern agriculture. Now these risks no longer exist.

The most obvious sphere wherein the interests of the United States and Russia coincide is coping with global problems, especially in the security area. Confronting terrorism has long been the main channel of cooperation between the two countries. ISIS is the major threat to global security now, and to address it, the cooperation of the United States and Russia is critical.

The central bilateral question between the two nations remains the fate of the sanctions regime. The divide between the Trump administration and the political establishment on globalization is mirrored in the divide on Russia policy. The political establishment remains largely committed to sanctions against Russian behavior in Ukraine and, putatively, the U.S. election process. The Trump administration, in contrast, seems ready to propose the opportunity for a grand bargain in which each nation's core interests are respected, particularly insofar as they do not overlap. However, the pressure of Trump's opponents regarding Russian policy is so strong that the new president had to toughen his rhetoric against Moscow. It puts into question the optimism about U.S.-Russia relations appearing after the most recent presidential election.

In the present political landscape the development of any economic cooperation between the two countries is complicated. There could have been such promising fields of cooperation as joint energy projects, including those in the Arctic; participation of U.S. companies in accelerated development in the Russian Far East; and IT technologies and venture businesses. However, sanctions make such collaboration nearly impossible.

However, even without the lifting of sanctions, U.S.-Russia cooperation may go far beyond concrete economic projects. What the two countries are able to do together is maintain the sustainability of the world economic order that nowadays faces one of the strongest transformations in modern history. In particular, Russia has a positive role to play in helping to avoid a major confrontation between the rising power (China) and the declining power (the United States). The last time an era of globalization ended—1914–45—the world was more violent, and the entire system collapsed. Nowadays, the fragmenting of the world economy is hard to reverse, but both Russia and the United States might be able to play a coordinated and positive role in making sure that the regional systems which emerge are open to one another, as opposed to compartmentalized.[19]

What the two countries are able to do together is maintain the sustainability of the world economic order that nowadays faces one of the strongest transformations in modern history.

[19] P. Katzenstein, 2005. *A World of Regions: Asia and Europe in the American Imperium*. Cornell University Press.

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The Working Group on the Future of U.S.-Russia Relations convenes rising experts from leading American and Russian institutions to tackle the thorniest issues in the bilateral relationship. By engaging the latest generation of scholars in face-to-face discussion and debate, we aim to generate innovative analysis and policy recommendations that better reflect the common ground between the United States and Russia that is so often obscured by mistrust. We believe our unique, truly bilateral approach offers the best potential for breakthroughs in mutual understanding and reconciliation between our countries.

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