



Letter n°12

What are the risks and impacts on the financial markets of questioning multilateralism ?

« *Challenge yourself to your optimism, and imagine that we are in this world to fight against all* » Prosper
Mérimée

The year 2008 remained as the birth year of the G20, of concerted action to emerge from the crisis. The year 2020 is marked by the failure of multilateralism, the aggravation of Sino-American rivalry and the exchange of acrimonious messages between various powers. Once again, the reproach addressed to globalization for impoverishing the middle classes of developed countries, omitting one of the benefits of globalization that lifted more than a billion people out of poverty over the last twenty-five years. Once again, the indictment of strained flows in global production chains, the concealment of an international trade reality, mostly composed of intermediate products, and the ignorance of the risks for emerging countries of a return to protectionism.

We Europeans are undoubtedly a little short-sighted about the international order and the effectiveness or limits of multilateralism. Europe has faith in multilateralism because, for the first time in history, it has not known war for 75 years (with the exception of Bosnia and Donbass). In the meantime, however, conflicts outside Europe have been numerous and have shown the limits of multilateralism, hampered at the United Nations by the veto of any member of the Security Council. At the same time, with the US, political relations are waning, trade relations are harsh, multilateralism is being undermined and military protection is more uncertain. The latest threat is Trump's indication to withdraw a quarter of US forces from Germany.

To assess the risks of a challenge to multilateralism in the financial markets, we will examine the Chinese assertion, the American retreat, the cost and ineffectiveness of American sanctions against China. It will be shown that relocations, even if subsidized by the countries, will take time and remain limited as the attractiveness of a Chinese market of 1.4 billion population persists even for American firms.

Between Chinese assertion, American failures on the international scene and the temptation to retreat.

The US, since its constitution, has always oscillated between an active role on the international scene and isolationism. Its retreat after World War I aggravated after the 1929 financial crisis. Its reluctant entry into war after Pearl Harbour in December 1941 was decided only by a one-vote majority in Congress because President Franklin Roosevelt had struggled to drag the American people into this war. Then, it assumed an active role until the last few years.

The Chinese assertion :

China is the undeniable economic success of the last thirty years, however it is also experiencing a structural slowdown in growth and now a political ambition to assert itself on the international arena, which is not always well-received by neighbouring countries and other major powers.

Its economic success in a few figures: the China GDP was \$1.1 trillion in 2000, dismal compared to \$14 trillion in the previous year. In 2000, China GDP per capita was only 6% that of the US, today it is nearly 30%. China's success is industrial, with a third of the world's textile production, more than 50% of steel and cement production and 40% of telephone equipment. China is also the world's leading exporter with 12.8% of the total in 2019 against 8.5% for the US, 8% for Germany and 3.8% for Japan; it is the second largest importer with 10.8% against 13.2% for the US. China seeks to establish global leaders in each of the major sectors and thus, in the latest Forbes ranking of the world's top 500 companies, it has 120 companies, including the top four

banks, compared with 126 for the US, 52 for Japan, 32 for Germany and 28 for France. The Chinese breakthrough is increasingly noticeable in research with 22% of global spending in 2017 against 25% for the US. According to World Intellectual Property Organization (WIPO), the number of patents filed by China in 2018 is approaching that of the US, ahead of Japan and double that of Germany. According to the World Economic Forum, China now trains seven times as many engineers as the US and intends to maintain its lead in key sectors such as electric batteries, where the world's leader, CATL, with more than a quarter of the market, is Chinese and ahead of Japan's Panasonic.

In addition to developing the domestic market, China has in recent years been working to increase foreign investments and forge economic and political ties with some 120 countries along the Silk Roads, both land and sea-based. This is a reversal from the development after the collapse of the Mongolian empire in the wake of the Black Death. This was the origin of the Silk Roads, but the Ming Dynasty chose the path of retreat, stopped explorations in the Indian Ocean by Admiral Zheng He and his fleet of 300 ships, and missed the trade boom that began with the Renaissance.

Anxious to secure its oil supplies, China, the main importer of crude oil, moved closer to Iran and Saudi Arabia, occupying a place vacated by the US and circumventing, if necessary, American sanctions against Iran.

The political ambition, in a few manifestations: first in the China Sea, roughly the size of the Mediterranean, China has exhibited a desire to strengthen control of the Paracel Islands, by establishing a research centre in the Spratly Islands and the boarding and inspection of a Vietnamese boat, in defiance of complaints from Malaysia, Vietnam and Philippines. It is also demonstrated by a tightening grip on Hong Kong, which was ceded to the British in the 1842 Treaty of Nanking, and subsequently recovered in 1997 under the terms of the "one country, two systems" agreement. This assertion also extends to Taiwan and the disputed territory of Kashmir, a renewal of tensions with India, the reawakening of the 1961 conflict spectre.

In Europe, China is leading a campaign to denigrate the democracies and to seduce the weaker links in the Union - Greece, Italy, Portugal and Hungary - in order to play on European divisions. The EU-China summit scheduled for mid-September has just been cancelled; Europe is trying to define a policy to regulate Chinese purchases of European companies and establish its independence in strategic sectors such as the healthcare sector.

American failures and the American temptation to retreat :

The American position towards China has changed. In 1949, despite the victory of the Chinese Communist Revolution, the US preferred to back Mao, a possible ally in the fight against Stalin, and to ignore the Formosa regime led by the nationalist Chiang Kai-shek. The US did not want to support a regime that was probably doomed, and Dean Acheson, then Secretary of State, had not included Taiwan in the geographical perimeter to be protected. It was on 25 June 1950, during the invasion of South Korea by northern communist troops that General MacArthur saw Taiwan as an "unsinkable aircraft carrier" useful to American forces. Since then, China and the US have held opposite sides in Korea and Vietnam, have shared close relations in the fight against nuclear proliferation in Korea and Iran. Conciliation has often prevailed before Trump.

Vis-à-vis the rest of the world, the US is tempted to retreat because it often fails to impose its point of view: the Mexicans refused to finance the wall, the Germans obtained the construction of the Nord Stream II pipeline for the supply of Russian gas, the Turks bought Russian military equipment, a majority of countries objected to the transfer of the Israeli capital to Jerusalem, almost all countries criticized the exit of the Paris Climate Agreement, and the Americans cannot oppose the assertion of China or even India.

American resistance to multilateralism does not date from the Trump presidency. Before him, the US had refused to endorse the creation of the International Criminal Court (ICC), had not ratified the treaty banning anti-personnel mines, nor validated the nuclear test ban treaty.

Currently, the US still spends more on its defence than the other major powers combined, but it seems tired of being the world's policeman, thus is withdrawing troops in Iraq, Afghanistan and Syria, is thinking twice about its military presence in Europe. Trump considers the years of the American crusade for democracy to be a failure.

Between the cost of sanctions against China and their low effectiveness.

Between Trump and China, it is no longer just a question of trade but of geopolitical rivalry. For many reasons, we cannot seek a comparison with the past rivalry between the US and the USSR: trades between the two were non-existent at that time, however now they are significant between China and the US; the presence of American firms in the USSR was nil, it is developing in China.

Firstly, let us analyse the ineffectiveness of the measures against China, and secondly, the persistent attractiveness of the Chinese market for Western firms.

Ineffective measures against China :

The diversity of sanctions: after the increased tariffs in 2019, the Americans want to restrict the access of Chinese companies to Wall Street on the grounds of a lack of accounting transparency. The 650 or so Chinese companies listed in the US, of which around 60 since 2016, account for more than 3% of the American market capitalisation, or around \$1 trillion, with Alibaba accounting for more than half of this value. Is it wise to restrict Chinese access? Isn't it encouraging Chinese companies to only list domestically? After all, China has established a "Nasdaq-style" board for its many technological companies, and Baidu is reportedly considering to delist from Nasdaq. Other measures taken by Trump include putting pressure on the Taiwanese company TSMC to invest in a \$12 billion plant in Arizona and not to supply new applications to Huawei, as well as banning US companies from selling components to Huawei. Finally, the Americans are watching on the sidelines, with UK PM Boris Johnson irritated by China's handling of the Covid-19 crisis and the escalated measures taken in Hong Kong, is considering closing its 5G market to Huawei in 2023, which would see the tech giant lose its largest market in Europe.

Lack of benefits for the US: to help reduce the US-China trade deficit of \$420 billion in 2019, China had committed in January 2020 to purchase \$200 billion in additional products from the US, but American exports to China have instead fallen by 11% in the last few months, and recently the Chinese have apparently halted purchases of US soybeans and pork. While the American ire is understandable, the sanctions applied have more drawbacks than advantages and one cannot forget the US dependence on foreign capital, since budget deficits and current account deficits have been accumulating for decades. At the beginning of the 2000s, the Americans were satisfied with the relationship with China: they were buying cheap "Made in China" products, the Chinese were investing their trade surplus in US treasury bonds, and so US consumers could continue to borrow at low rates. The situation is changing: China represents only 18% of US imports and 6% of its exports in 2019. For example, Americans sell more soybeans to the European Union and Mexico than to China, and Chinese savings are concentrated more onshore these days.

Trump has increased customs duties but without success. This is evidenced by the statements of **Tomas Philipson**, chief economist of the Trump administration, as he recognized the damage to economic growth caused by the trade war initiated by Donald Trump. For the year 2019, the Fed has evaluated that the tariffs imposed on China and other retaliatory measures such as the taxes on European steel and aluminium costs the American and global economy 1% of GDP growth.

There is a general temptation to relocate factories out of China: Taiwan has spent more than EUR20 billion in the form of tax cuts and installation incentives to facilitate the return of nearly 200 Taiwanese companies established in China. Japan is allocating more than EUR2 billion to help companies repatriate activities that had been relocated to China. South Korea wants to do the same, as do European countries and the US. Relocating, whether or not in strategic and promising sectors such as health, digital, renewable energies, does not necessarily mean giving in to protectionist measures, and it presupposes the organisation of regional sectors, human and financial investments, adapted infrastructures, appropriate taxation and export objectives. In the health sector, Western countries have left, perhaps mistakenly, the production of more than 80% of paracetamol to China, but they are still very strong in this sector and are making significant surpluses. A repatriation, which entails construction and opening of factories in Western Europe, could take three years. If decided, relocations will be in the interests of supply diversification: from China to the countries of Southeast Asia for production units in technology and electronics; from China to Burma, Bangladesh and Cambodia for textiles; from China to Morocco, Turkey, Slovakia and Mexico for automobiles. However, relocation will not always be synonymous with competitiveness and production costs could be higher if higher environmental standards are added. Finally, none of these measures, sanctions or relocations will likely erase the US trade deficit. In 2019, despite Trump's posturing, the US trade deficit was reduced by only 1.7% and still stood at \$615 billion, or 2.9% of GDP.

The Chinese market is unavoidable : three points stand out.

China remains a driving force of global growth: since 2008, it has stimulated global growth by erasing most of its current account surplus of 10% of GDP. In some years, it has been responsible for 35 to 40% of world growth and today accounts for 18% of world GDP. It has not given in to the temptation of a currency war, even though CNY against USD is currently at a low point.

China remains attractive: with its 1.4 billion inhabitants and a middle class of more than 300 million, it attracts multinationals, especially American firms that have invested \$14 billion in 2019. Recently, Walmart, Tesla, and also Volkswagen in the electric car segment, have increased their presence; Fidelity after BlackRock is establishing itself to access the world's third largest fund market valued at \$5.3 trillion; HSBC has just taken control of its insurance branch and Credit Suisse of its local subsidiary. The Chinese market remains attractive in diverse sectors such as insurance, banking, automobile. We have even seen HSBC and Standard Chartered take a stand in favour of China after the recent adoption of the security law in Hong Kong.

China is adapting: in order to speed up the achievement of its technological independence plan "China 2025", the government, according to Bloomberg, has set aside EUR1.25 trillion for investment in technology. In implementing its stimulus policy, Xi emphasizes the sectors of the future. Even if there is no Chinese among the world's 15 largest semiconductor manufacturers today, this situation will not last and the Americans will lose an opportunity in a sector of excellence. In response to recent US blackmail, Beijing has injected more than \$2 billion into the country's national semiconductor manufacturer, SMIC. Another Chinese priority is its nationwide rollout of 5G network, and the three major operators (China Unicom, China Mobile and China Telecom) are working on it. By the end of this year, 70% of 5G users worldwide are expected to be Chinese. At the same time, Huawei, the global leader in several telecommunications segments, with a turnover of \$120 billion, has begun local production of components, particularly semiconductors, to reduce its dependence on overseas sources. The Financial Times estimates that 42% of a current phone's components are Chinese and only 1% are American components, in this case Qualcomm chips. So relocation is not just for Westerners!

Conclusions :

Concerns about dependency are reciprocal and the expansion of international trade should be hindered: while Westerners are alarmed about their dependence on Chinese factories, China is also worried about American blackmail on their technological ambitions. Both want to relocate and reduce their dependence. After 1945, the growth in trade had been double that of global GDP and had been an engine for growth, we remember that during the 1929 crisis, the volume of international trade had contracted by a third within three years and in 2009 trade had fallen by 13%. This year, the World Trade Organization (WTO) fears a trade contraction of 13 to 32% and is worried about the temptation of a retreat that is running through many countries.

Concerns about employment are excessive and multilateralism must be reaffirmed: in recent decades, foreign investments of large Western firms have more often aimed at conquering new large markets, such as China and India, than at reducing costs. The loss of industrial jobs in the West has resulted more from productivity gains than from relocation. Multilateralism is a must because this crisis is affecting our world, as in 2008 the financial crisis did, as too often terrorism does and as tomorrow a climate crisis could do.

Relocations should be less than estimated: people are a little ambivalent. As voters, they are campaigning for the repatriation of activities, or even the closure of borders. As consumers, they always want the cheapest products. Today, a disagreement is perceptible between governments and firms. The former, for political reasons, are pushing for repatriation, while the latter, anxious to make the most of it, are often reticent. For example, in South Korea, a country dependent on exports for 60% of its GDP (particularly to China, its leading partner), the government is encouraging the repatriation of activities, but it would appear that only 3% of industrial companies are considering this option because they do not want to risk losing access to the massive Chinese market and losing competitiveness in a Korean market that is more heavily taxed and more regulated. From these conflicts of interest, one can speculate on the repatriation of some activities considered strategic, particularly in health and renewable energies, but this will take several years because it requires a trained labour pool, appropriate tax conditions and assured competitiveness. In the meantime, and anecdotally, the French government today prefers to buy masks produced in Vietnam rather than those produced more expensively in France. It is not certain that relocations will create many jobs and robotization could be one of the keys to competitiveness.

*Protectionism is the only risk for financial markets: if protectionism were to prevail, inflation would accompany, emerging countries would be the big losers and financial markets would retreat. If the generous state subsidies currently granted to companies in difficulty allow the survival of doomed companies, they distort competition. It is to be hoped that these measures will remain temporary because, as **Julien Gracq** recommended in Le Beau Ténébreux, "**Never reinforce the weak points, always reinforce the strong points**".*

Geneva, June 9, 2020



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