Letter 45

When relocation could rhyme with inflation and immigration.

“People only accept change in necessity and see necessity only in crisis"

Jean Monnet

The crisis has spurred the reflection on 4 words: openness, imbalances, dependence, and relocations.

- ***Openness as a trend***: globalization has accelerated in recent decades. It has led to a rise in living standards around the world, especially in emerging countries. It has led to an increase in inequalities, especially in developed countries.

- ***Imbalances as a consequence***: in the United States and France, the trade deficit is too high, and we must find ways to reduce it. The gap between imports as a percentage of GDP and exports is too large: 16% of GDP in 2019 for US imports against 13% for their exports, 24% against 22% in France respectively. This leaves a structural deficit to be filled and relocations can be a way.

  Conversely, Xi is right to want to reorient the Chinese growth model towards domestic consumption because the trade surplus is so large, with exports at 17% of GDP against imports at 14% of GDP, that it exposes itself to the wrath of the major countries and protectionist measures.

  Germany, with exports at 41% of GDP and imports at 33% of GDP, is measuring its international dependence this year and its industry is suffering from the Chinese slowdown as well as from shortages.

- ***Dependence as a risk***: the Covid crisis, the disruptions in production chains, the delays and even interruptions in delivery from Asia have opened the eyes of Europeans and Americans alike to their dependence on Asia, especially China. Today, the GDPs of the major countries, with the exception of Great Britain, have recovered or even exceeded their pre-crisis levels, but industrial production is far from having returned to its previous level.

- ***Relocation as an aspiration***: this word is making a fortune in all developed countries and, with various accents, is of interest to all political parties, left and right.

In order to absorb or overcome these dependencies, many countries have laudable objectives of strategic stocks, diversification in supply chains, and relocation of production chains in regional areas.

Some would like to go further, to move towards protectionism but, undeniably, there would be more to lose than to gain for the standard of living.

In history, there are many examples of the evils of protectionism, and we will limit ourselves to recalling the most famous and the most costly, that of the closure of China in the 15th/16th century. At that time, China was the world’s leading power, but it had declined considerably from 20% of world GDP, according to the calculations of Angus ***Maddison*** at the OECD, to 5% under Mao.

Therefore, in the first part, we will define the ambition of these relocation projects and, in the second part, identify the stakes.

SINGALLIANCE
SingAlliance (Switzerland) SA | 16bis rue de Lausanne 1201 Genève Switzerland
T: +41 22 518 85 85 | www.sing-alliance.com

The ambition:

- ***One observation: deindustrialization has been rapid***. 3 preliminary remarks and 2 consequences:

Deindustrialization, measured by the weight of industry in GDP or the percentage of jobs in these sectors, has been *a general phenomenon in all developed countries* since the 1970s but it is partly the result of the outsourcing of certain functions to service providers (for example, if Ford outsources office cleaning, there are fewer jobs counted as industrial, but production does not decrease). According to INSEE, in France, since 1980, 25% of the industrial jobs lost are in fact transfers to services.

Deindustrialization is not attributable to relocations alone: the richer a country is, the older the population becomes, the more services it consumes.

Deindustrialization, measured by the decline in the share of industry in GDP, *is not necessarily the consequence of a decline in volumes* but the result of a fall in relative prices compared to the service sector since productivity growth is higher in industry.

Job losses: according to ***Acemoglu,*** Chinese competition accounts for a quarter of the 4 million manufacturing jobs lost in the United States between 1990 and 2011. According to ***Kotkin,*** globalization and offshoring have cost 3.4 million manufacturing jobs in Britain.

Wage stagnation: as a result of the contraction of manufacturing employment to less than 12% of total employment in the OECD from 18% in 1995 and the development of low-skilled service jobs, wages have stagnated for decades.

In 2019, industry, as a percentage of GDP, still represented 24% in Germany, 19% in Italy, 18% in Sweden but only 15% in Spain, 13% in France and even less in the United States and Great Britain.

<u>A regional example: France.</u> In 30 years, France has lost 30% of industrial jobs and according to the CAE (Council of Economic Analysis), the number of jobs in the automotive industry fell by 36% between 2000 and 2018. As a result of this deindustrialization, the trade deficit is structurally high, not so much with the emerging countries, €10 billion deficit, but with the countries of the European Union, more than €55 billion. The causes are labour costs, insufficient business investment, taxation, corporate tax, and production charges.

The country's dependence on imports for end consumer goods, such as automobiles and household appliances has become strong in recent decades. The same applies to dependence for intermediate consumer goods, e.g. electronic components, active ingredients in the pharmaceutical industry.

Admittedly, the attractiveness of the country has improved in recent years, but French companies invest twice as much abroad as foreigners invest in France. Certainly, 14,000 foreign companies, including 4,500 American, are located in France, employing 13% of the workforce, and accounting for 30% of French exports. It is true that Americans have recently invested more in France than in Germany or Great Britain, but the trade deficit persists, representing 2% of GDP while Germany's trade surplus amounts to 8% of GDP, Spain has a slight surplus, Italy has a surplus of 3% of GDP. If French productivity is higher than that of its neighbors, it is a consequence of the disappearance of unskilled jobs (gas station attendants, motorway toll booths, etc.). Working 15% fewer hours than its major competitors condemn the country to relative impoverishment.

The current policy of reindustrialization involves 600 projects supported by the state, and 70,000 jobs

SingAlliance (Switzerland) SA | 16bis rue de Lausanne 1201 Genève Switzerland
T: +41 22 518 85 85 | www.sing-alliance.com

have already been created, for example, in the production of paracetamol, but it must be expanded.

A topical sectoral example: semiconductors. 20 years ago, the United States produced 18% of the world's semiconductors, today, it is 9%. They want to increase subsidies from $50 billion to $100/200 billion to relocate semiconductor production.

In Europe, in the space of twenty years, the market share in the semiconductor market has decreased from 24% to 7% and the same has been true in Japan, from 16% to 14%. Today, Europe wants to ensure its digital sovereignty and semiconductors are one of the areas but only €20 billion is budgeted as part of the European recovery plan against $400 billion in China.

At the same time, China's share rose from 1% to 21%, South Korea's from 14% to 24% but Taiwan's from 23% to 19% (according to Kearney).

The number one player is TSMC in Taiwan, a producer of more than half of the world's semiconductors and engaged in a $100 billion investment program. The major European companies are the Dutch ASML, one of the largest European capitalizations, followed by ST, Infineon, NXP, Siemens EDA and Soitec.

The shortage of semiconductors supply is glaring and affects sectors such as automotive industry and equipment manufacturers. The automotive industry, because world production is cut by 7 million this year, and the equipment manufacturers, because Kearney estimates a €50 billion loss of turnover this year.

Contrary to an opinion in vogue thirty years ago, which favored the relocation of factories to emerging countries, the presence of industries in a country favors the networking of territories, offers qualified jobs that are often better paid than in services and brings higher productivity gains than in some services.

- ***One main objective: reducing dependency***.

Dependencies develop over time, but they also emerge when there are diplomatic tensions: we remember the freezing of wheat exports by Russia in 2010, the brakes on rare earth exports imposed for a time by China and, symmetrically, the ban issued by Trump to sell electronic components to Huawei and SMIC, two Chinese companies.

The Covid crisis was a wake-up call that highlighted the dangers of dependence on China and awakened the desires for renewed independence.

Geopolitical dependence on China:

Yesterday, with the USSR, the rivalry was military, today, with China, the competition is technological, and the interests are shared on the climate. Yesterday, with the USSR, there was little trade, today China is the 2nd partner of the United States after the EU and, in 2019, provided Americans with more than a billion goods per day.

In the space of three decades, China has become the factory of the world and as ***Esther Duflo,*** recent Nobel Prize winner in Economics, has written in her excellent book ***"Good Economics for Hard Times",*** the country relies on many specialized and very competitive "clusters", such as the city of the shoe, the city of the shirt...

Moreover, in recent years, Xi has promoted a policy of international expansion to more than 100 countries, cleverly disguised behind the pretty term "Silk Roads."

Faced with the accumulation of tensions, and with the accusations that the Chinese are subsidizing their exports and favoring their national champions, some fear a shift towards a confrontation between blocs and want to block technology transfers, but let us make no mistake, the shortages, yesterday of masks, today of building materials, toys or others, are not the result of Chinese obstacles but of a surge in Western demand.

Protectionism cannot be the solution, but the cards are being reshuffled, economically, politically, and financially:

<u>The economic angle</u>

Since the end of the first wave of Covid, there has been an influx of orders for consumer goods, a sharp increase in maritime cargo traffic, to the benefit of China.

But China is gradually losing its costs advantage, as evidenced by the latest price index in October, a 12.4% year-on-year inflation in production costs.

In addition, power cuts, container shortages, rising freight costs on shipping routes from Asia are exacerbating delivery delays. A shortage of container ship capacity is likely to persist until the delivery of ships from 2023.

In response, developed countries that want to reduce their dependence, encourage relocations.

The Chinese government, sensitive to these developments, has announced the creation of a third stock exchange in Beijing, after Shanghai and Shenzhen, with the aim of attracting innovative SMEs. It is multiplying the pressure on Chinese companies to abandon listing in New York and has implemented a $1.25 trillion "China 2025" with the ambition of achieving technological independence in some clearly identified sectors such as semiconductors, robotics, artificial intelligence ...

<u>The trade angle</u>

While the Chinese government has set a target of reorienting its growth model towards domestic consumption and key sectors, it is not unaware of certain structural dependencies. In 1970, the country consumed 1Mb/d of oil, today it consumes 15Mb/d and it imports the essential. External dependence for gas was 15%, today it is more than 50%. Food dependence is even greater because to meet its food needs, China would need 2.5x more arable land. Clearly, globalization is an imperative for China.

Symmetrically and notwithstanding the ambitions of relocation to Europe, trade with China is growing rapidly. China accounts for 5% of European exports and 9% of imports. In 2021, more than 6,500 freight trains connect China compared to 400 in 2014. These trains, carrying about 40 containers, allow a journey in 3 weeks against 6 weeks by boat. The costs/container is €13,000 against €10,000/boat.

China has a trade surplus of €200 billion with the EU but, following the US measures targeting Chinese products, is concerned about the freezing of the trade agreement signed with the EU in December 2020, denounces the putting forward of political factors by the EU such as the defense of human rights, and deplores the hardening of the European trade positions and in particular a carbon tax on products such as steel or aluminum.

The political angle

The strengthened presence of the Communist Party in companies, the obstacles to the opening of the capital of companies to foreign interests, the advantage given to Chinese companies over foreign companies, state-owned enterprises over private enterprises, are bothering Western actors and leading them to think of alternative solutions.

The geopolitical angle

On the Silk Roads, the masks are coming off. China presented itself as a disinterested alternative to the former colonial powers, and the emerging countries aspired by a Chinese-led take-off are disillusioned.

The countries hosting Chinese investments are discovering that the Chinese are only thinking of facilitating access, here to mines, there to oil fields, and there to agricultural land. China wants to secure its strategic supplies, promote the sale of its products, use its labor abroad, facilitate the international expansion of its groups and faced with impecunious debtors, it does not hesitate to nationalize or take control of facilities, such as the port of Hambantota in Sri Lanka. Countries are distancing themselves, declining investment offers and dismissing this invasive investor.

Technological dependence:

All major countries, including China, aim to increase R&D spending, currently at 4.2% of GDP in South Korea, 3.5% in Japan, 3.4% in Sweden, 3.1% in Germany, 2.8% in the United States, and 2.2% in France.

Research spending raises barriers to entry and improves productivity.

The example of medicines

France was the leading manufacturer of medicines, but today it is in the 4th place. India is "the world's pharmacy" but 70% of the components are Chinese and Chinese drug prices are 40% lower than the international average. 80% of the drugs consumed by Americans have Chinese origin. 40% of the medicines sold in the EU come from other countries. The idea of Western countries is to build up stocks of medicines as there are stocks of oil. Europe, struggling with its shortcomings during the Covid crisis, wants to ensure its sovereignty for masks, vaccines, and medicines.

- ***A secondary objective: reducing the carbon footprint***.

Secondary should not be understood in a pejorative sense but, in the scale of greenhouse gas emissions, transport is far from being the main cause. Also, the idea for European countries is to repatriate activities from Asia to establish them in Morocco, Turkey or Eastern Europe.

The stakes:

Trump, at the end of his term, had initiated the relocation movement by promoting a partnership of public and private funding for the search for a vaccine.

Biden follows in Roosevelt's footsteps and reaffirms "big government." The stated objective is to promote American employment.

The same trend is observed everywhere in developed countries and is reinforced by the feeling of dependence born out of supply difficulties in certain sectors.

Alongside companies, governments can help to enter strategic sectors with significant fixed costs: we saw this yesterday with aeronautics in Europe and the United States, electronics in Japan, telecommunications in Europe, today, everywhere with support for renewable energies and healthcare and, at all times, in the defense sector.

But to relocate is to face additional costs, and therefore inflationary pressures and a problem of available jobs. These are the two points to be developed:

- ***How to manage the cost aspect?***

The WTO (World Trade Organization) condemns the idea of relocation. It considers it inflationary since it often involves subsidies, sometimes a national preference, or even protectionist measures.

Behind the word costs, there are tax attractiveness (the corporate tax rate is still 32% in France against 19% in the United Kingdom, 29% in Germany, 25% in Spain, 28% in Italy), external economies (quality of infrastructure...), the quality of the workforce (education and professional training aspect), the quality of research, innovation, the role of robotization and the diffusion of 3D, and wage costs.

With the incentives to set up and relocate, we are witnessing greater involvement of governments. We see this in Japan with more than €2 billion allocated to the repatriation of activities, because 20% of imported spare parts come from China. We see this in Taiwan, with €20 billion to facilitate the return of 200 Taiwanese companies based in China. We see this in France with €3 billion in support measures for some 620 industrial projects since 2020 to promote Made in France and, by 2030, the government wants to see the emergence of industrial champions in technologies of the future. But, in traditional sectors, such as textiles, despite the progress of robotics, going from 5% of production in France to 25% would be significant because many consumers will not want to pay more.

Notwithstanding these various aids, notwithstanding robotization, the short circuit does not compensate for the "low cost" from Asia. The "Made in Japan", “Made in US”, “Made in the UK” will result in additional inflation and burden the purchasing power of consumers.

<u>The sectoral example of solar panels:</u> in the United States, 85% of solar panels are imported mainly from China. Relocating will be expensive. Trump's tariffs on the import of Chinese solar panels cannot be the solution to allow the development of solar energy. Of course, Chinese subsidies must be fought, but the duties are paid by American buyers. It is preferable to move towards tax incentives for production or public orders, and the recently voted infrastructure plan aims to offer external savings to companies for better attractiveness.

In Europe, the idea of repatriating photovoltaic production is not won. In 2007, European market share was 30%, in 2017, it was 3%.

Relocations are difficult because international trade is less a trade of finished products than of components and intermediate goods. Trump's United States had wanted to repatriate a lot of subcontracting to Mexico, but the production remained in Vietnam or Thailand and Malaysia because of less corruption and higher efficiency. There remains Biden's reactivation of the "Buy American Act" perceived by NAFTA partners, Canada and Mexico, as protectionism.

SINGALLIANCE
SingAlliance (Switzerland) SA | 16bis rue de Lausanne 1201 Genève Switzerland
T: +41 22 518 85 85 | www.sing-alliance.com

- ***How to manage employment?***

With regards to the labor market, the desire to relocate comes at a bad time because, in many countries, particularly Anglo-Saxon countries, companies have difficulty finding employees.

In the United States, at the beginning of November, there were 7.4 million unemployed but 11.2 million unfilled jobs against 7.5 million before the crisis. This is due to the sharp increase in resignations, 20 million between April and September, a record since 2000. This is due to the reduction in the participation rate from 63.4% before the crisis to 61.6%, a decrease of 5.25 million in the number of people employed, of which more than 3 million correspond to early retirement.

In Britain, there are nearly 1 million unfilled job offers that do not seem to attract the British.

In France, there are 300,000 unfilled job offers. The north of the country is trying to revive the textile tradition, but it is difficult to find manpower and it takes time to train them.

In a few countries, there is a shortage of graduates. The percentage of 15–64-year-olds at or below bachelor's level is 47% in Portugal, 40% in Italy, 30% in Spain against 25% in France, 23% in the Netherlands, 19% in Germany and 17% in Finland. It is therefore necessary to increase the education budget but the effect is not immediate.

In the face of shortages, immigration, as we see in England, will be the solution and, in the meantime, wage increases are almost three times higher there than on the continent. It is thus paradoxical to see the far-right parties, which are opposed to immigration, being the most virulent supporters of protectionism because we do not see where the human resources will be.

As for the selective immigration, it deprives the emerging countries of their best elements, thus hindering the development of these countries and, indirectly encouraging the disadvantaged to emigrate as well.

Conclusion: ***"Do you not want to be wrong? Hold as false all the ideas dear to your time." Gustave Flaubert***.

Let us finish with the answer to 6 questions:

- ***What is the future for subcontracting?*** Globalization is fragmenting value chains. When Renault has 17,000 subcontractors, Pfizer has 5,000. When the manufacture of an integrated circuit can require up to 16,000 subcontractors in dozens of countries, there is no end in sight to this process.

- ***What is the future for repatriations?*** To date, surveys show that a minority of companies have decided to repatriate their production. Relocations have often been aimed at conquering the Chinese market or other large markets offering more attractive growth prospects than the European, Japanese or American markets. And if relocations aim to take advantage of low wage costs, only robotization, when possible, will be an alternative.

One thing is certain: the battle for competitiveness is won by supply-side policy and by investment and not by customs duties. Therefore, it will require significant incentives from the governments to possibly carry out relocations unless they are only incentives for electoral use.

- ***What is the future for zero stocks?*** Relocation or not, the majority of companies, outside sectors considered strategic, will keep the habit of zero stocks because it is a source of savings.

SINGALLIANCE
SingAlliance (Switzerland) SA | 16bis rue de Lausanne 1201 Genève Switzerland
T: +41 22 518 85 85 | www.sing-alliance.com

- ***What is the future for immigration?*** It has been and can be a factor in wealth creation.

- ***What is the future for US-China trade?*** There is talk of the Cold War between China and the United States but the daily exchanges between the two countries reach $1 billion while with the USSR, they were $1 billion / year. These exchanges will not disappear because they benefit both of them.

  According to the OECD, if in 2017 the US trade deficit with China reached $370 billion, in reality, it was only $110 to 120 billion because it was necessary to subtract $150 billion of assemblies, made by subsidiaries of American companies in China and correct the trade deficit of the US surplus of $45 billion in services.

  In addition, the American political will to isolate American tech groups, to deny them access to American territory does not prevent many private equity companies, such as Sequoia Capital or Matrix Partners, or even industrial groups such as Intel, Primarius Technologies co., a Chinese semiconductor company, to finance research or production activities in China. Since 2017, American groups have financed an annual average of 15 operations according to Rhodium figures. ***"The capitalists will sell us the rope with which we will hang them," said Lenin***.

- ***What is the impact on stock markets?*** If the world were to return to protectionism, there would be inflation and stock markets would fall, but that is not our scenario. No company wants to close the Chinese market and China cannot do without the world. The diversification of supply sources will take precedence over relocations, and these will be concentrated on a few strategic sectors supported by the states.

Geneva, 22nd November 2021

Bruno Desgardins

Bruno Desgardins
CIO
Switzerland

SingAlliance (Switzerland) SA
16bis rue de Lausanne
1201 Geneve
Switzerland
T: +41 22 518 85 85
E: info.switzerland@sing-alliance.com

SingAlliance Pte Ltd
20 McCallum Street
#18-01 Tokio Marine Centre
Singapore 069046
T: +65 6303 5050
E: info@sing-alliance.com

SingAlliance (Hong Kong) Ltd
1205, 12/F Bank of America Tower
12 Harcourt Road, Central
Hong Kong
T: +852 3611 7790
E: info.hongkong@sing-alliance.com