Letter n°53

From globalisation to possible regional blocs?

"Don't listen to what they say, watch what they do" Bergson

- There are many calls from governments to repatriate activities and many announcements of relocation by companies. But let's follow Bergson's advice: what is really going on? Is protectionism back? Is globalisation over? What will companies decide? What is the impact on the stock markets? What are the consequences for growth, purchasing power and inflation? These are just some of the questions to be addressed in this Letter 53.

- Since 1945, governments and companies seemed to share the same faith in trade liberalisation. International trade served peace, relocations benefited purchasing power, companies gained access to new promising markets such as China and India.

- In recent years, the approach is changing, globalisation is being challenged, the benefits are being put into perspective, the harms are being highlighted. There was Trump and his policy of tariffs against China. There has been Covid and the perception of dependence on sectors as strategic as the pharmaceutical industry. There is now the Russian crisis and the ill-feeling of energy dependence. There is also the energy transition to be ensured and this involves local investments in renewable energies.

- There are various incentives to relocate, as well as pressures for a re-engagement of the government in the management of economies, and, incidentally, as many inflationary pressures.

- Is globalisation under threat? Can companies still build their international network according to opportunities? Can the optimisation of profit and asset allocation still take precedence over the national interest?

Globalisation and its benefits:

Globalisation has been driven by multilateral bodies. Replacing the GATT, the General Agreement on Tariffs and Trade, established in the aftermath of the Second World War, the WTO, the World Trade Organisation, was created in 1995 during a period of euphoria over the opening of borders.

With the USSR gone, the former communist countries joined multilateral organisations to develop trade, some like the Baltics in 1999, others, later, China in 2001, Vietnam in 2007, Russia in 2012.

2008 was, according to the WTO, the peak of globalisation with world trade accounting for more than 30% of world GDP.

Globalisation has enabled increased mobility and access to affluence in many countries and sectors. It has lifted tens of millions of people out of poverty in emerging countries and offered gains in purchasing power in developed countries. According to the Banque de France, these low-cost imports have brought more than €1,000/year in purchasing power gains to consumers.

Globalisation and its critics:

In developed countries where social protection did not act as a buffer, globalisation has weakened the middle classes.

Since 2008, there has been a regression observed and by 2020, trade has fallen to 26% of global GDP. Similarly, according to the WTO, trade impacted by tariff barriers has increased from $125 billion in 2010 to $1.5 trillion.

The multiplication of trade sanctions initiated by Donald Trump against China, the awareness of health and industrial dependencies arising from the Covid crisis, the European desire to emancipate itself from Russia for the supply of hydrocarbons, and the closures or disengagements decided by many Western firms in Russia are weakening free trade.

- ***The march towards the regionalisation of trade***:

The war in Ukraine shows the impossibility of trade to ensure peace, the opposite of the initial ambition of the GATT. The tendency to cut Russia off from the rest of the world – blockade and withdrawal of international firms – could leave traces and cause a split between free bloc and authoritarian countries.

Relocation is high on the agenda of many ruling parties in Western countries. This does not mean protectionism, but an increased regionalisation of trade between neighbouring countries, for example a strengthening of cooperation between EU countries or between the United States, Canada and Mexico.

These relocations will take longer than we think because they cannot take place without investments in infrastructure and especially in education and training in order to have the required workforce.

Between a Russia that is not going to fall because of sanctions but is going to suffer a severe recession, a Europe that is thinking of a new debt mutualised to promote energy independence and strengthen the continent's security, a China that does not want to face new American sanctions, let's examine the policies of three blocs on this theme of more self-centred growth.

- ***Independence as seen from Russia***:

The Russians, after the sanctions related to the invasion of Crimea, have invested to gain autonomy in many sectors, from agriculture to industry. The Russians (see our previous Letter) have also reduced public debt, diversified foreign exchange reserves and initiated an alternative to Swift. With the Mir card, which accounts for 25% of transactions, they have the first steps of a substitute for the American credit cards Visa and Mastercard, now blocked and we bet that they will accelerate in these directions.

However, Bitcoin is not an alternative because, apart from the fact that payments in Bitcoin are not anonymous, its capitalisation does not exceed $850 billion. It is volatile and stablecoins are worth only a few billions.

The freezing of the central bank's assets hinders the defence of the rouble. Inflation could exceed 20% and the economy could experience a recession of 8 to 10%.

Russia will want to strengthen its independence but a rapid severance of ties with the EU is impossible and unlikely. In 2020, Russian exports to the European Union accounted for 40% of the total, far ahead of China, 14.5%, and the United States, 3.2%.

Another perennial weakness, often mentioned, is the low diversification of Russian exports: 40% hydrocarbons, 10% metals and metal products, 9% agri-food, 7% chemicals.

Russia will not cut itself off from the world, the stock of FDI (Foreign Direct Investment) will remain close to $500 billion. The flow of FDI has certainly decreased since the 2008 peak of $75 billion and will not exceed $10 billion in 2020, companies are withdrawing but not all foreign companies are closing their facilities. There is a lot of talk about the (temporary?) closure of McDonald's, Western banks or oil companies, the withdrawal of some 400 foreign companies according to an estimate by the Yale School of Management, for example, Deloitte and Ernst & Young but we fail to mention all the companies that remain. Topical, these American oil companies, Halliburton or Schlumberger, are still active in the service of Gazprom and Rosneft or Chevron which transports Russian oil by ship to sell to the Europeans.

For the time being, everyone is talking about sanctions but gas sales to Europe through pipelines are higher than before the conflict (350 million m3/d against 270 million m3/d) and LNG sales by LNG carriers continue. Oil sales are also being maintained and, by the end of 2022, if the EU reduces its dependence by two-thirds as announced, India and China will be able to replace each other.

- ***Independence as seen from China***: the quest for autonomy but awareness of dependence.

The tariffs, unsuccessfully imposed by Trump in 2018 against China and maintained by Biden, are in fact paid for by the American consumer and have not stopped China from taking its exports to a record high in 2021.

The Chinese, since the implementation of sanctions and high taxes by the Trump administration, share the same concern for independence as the Russians. They have not met the target of increasing their purchases in the United States and are pursing the "China 2025" plan to gain technological autonomy.

But, there are 4 arguments to support the view that China cannot close itself to the world:

First, it accounts for about 16% of world exports and 12% of imports.

Secondly, in 2021, it still received some $300 billion in FDI (Foreign Direct Investment) and has an FDI stock of nearly $3.5 trillion.

It also manages nearly $3.2 trillion in foreign exchange reserves, a third of which are in US Treasury bills.

Finally, it is dependent on raw materials, agricultural products and some industrial and technological components. China acquires a quarter of the 6.5Mb/d of oil exported by Saudi Arabia, a third of the oil exported by the Russians and globally, it is the world's leading importer of crude with 15Mb/d.

In the conflict in Ukraine, the Chinese are annoyed that the war is disrupting the only functioning silk roads as trade stagnates between China and Africa as well as between China and Southeast Asia.

China remains cautious and does not want to get angry with the West: it makes only $70 billion in exports to Russia against about $580 billion to the United States and $500 billion to the EU, countries that it cannot do without for technology. Russia is only China's 13th largest customer. The gas pipeline recently linking the two countries has a capacity of 38 billion m3/year but deliveries were only 10 billion in 2021 against 150 billion sold to the EU.

However, it is difficult for the West to put pressure on China if they themselves remain so lax on sanctions.

Chinese growth will continue to benefit from exports because the government's desire to favour domestic consumption not only comes up against the rapid aging population (the over 65s should represent a quarter of the population in 2040) in a context of negligible immigration but also comes up against the constraints posed by high debt. In addition, there is a lack of household confidence and precautionary savings to compensate for the low pension spending at less than 6% of GDP.

- ***European ambitions***:

The European recovery plan, €750 billion, decided during the Covid crisis, provides for investments in strategic sectors such as semiconductors, batteries, hydrogen, healthcare and, perhaps tomorrow, agriculture.

Such investments will result in a rise in manufacturing employment as a percentage of total employment. It is still necessary to have the required qualified workforce. Investments in training will be needed, wage increases and increased immigration will accompany these strategic choices.

To date, the EU’s energy balance sheet draws only 16% from renewable energies and 13% from nuclear, and is far from having finalised its energy transition since oil represents 36% of the energy consumed, gas 22% and coal 13%.

The war in Ukraine, which reveals Europe's energy dependence on Russia that is a quarter of imported oil and 40% of gas, is accelerating the debate on a Europe of energy and, no doubt, under the aegis of NATO, a Europe of defence. A €2 trillion plan, 2/3 for energy, 1/3 for defence, financed by a pooled debt is being studied.

If Europe wants to stop depending on Russia by 2030, as the President of the European Commission hopes, it will be necessary to invest massively in renewable energies. From 20 Gigawatts installed each year since 2016, solar and wind capacities will have to be multiplied at least by 7 times, solar being clearly favoured over wind.

Investments in nuclear and other renewable energies are expensive and the energy transition presupposes the closure of facilities, coal-fired power plants for example, and therefore asset depreciation borne by firms and governments.

In the meantime, to reduce dependence by two-thirds by the end of 2022, it will be necessary to resort to liquefied gas.

On defence progress, the Atlantic alliance, NATO, seem to take precedence over the European approach and it is symptomatic to see Germany, Belgium, Finland and, outside the EU, Switzerland buying American equipment, including the F35 aircraft.

In relations with Russia, the EU with $100 billion in exports to Russia cannot have such clear-cut position as the United States, whose exports do not exceed $10 billion.

Conclusion: the pragmatism of firms should take precedence over political dirigisme.

- ***An increase in inflation***: this could be the consequence of this reorientation of trade and relocations.

- ***A risk of monetary deglobalisation***: the seizure of Afghanistan's assets abroad after the Taliban took over and the freezing of Russian assets in Western currencies could encourage some countries to think about the composition of their reserves but, to date, the alternatives are not very significant: the Yuan is still not widely used and does not offer all the guarantees of liquidity and recovery even if Saudi Arabia studies the possibility of a settlement in Yuan for Chinese oil purchases. Gold is a possibility but the market is modest. There remains the possibility of increased funding in local currency. India is considering buying Russian oil in rubles and/or rupees to circumvent US sanctions, but the slightest holding of foreign currency will aggravate exchange rate instability. Meanwhile, the $ still represents 59% of the world's foreign exchange reserves ahead of 20% for the € and nearly 6% for the Yen, and the $ finances 80% of oil transactions.

- ***Russia could see a new wave of brain drain***: if Europe loses a little more than one percentage point of growth this year, Russia will lose more than 10 points and this will encourage qualified young people to leave the country. Significant emigration during the crisis of the 90s has continued under President Putin, and is estimated by the Atlantic Council to have involved more than 1.6 million qualified people between 2000 and 2018, and this could increase if the crisis persists.

- ***A policy of blocs would not be in China's interest***: pragmatically, the Chinese are aware of the fragility of their growth because the country is heavily indebted and the population is declining. Pragmatically, they know how intertwined their economy is with the rest of the world. Pragmatically, they know the country's dependence on agricultural raw materials and energy. Pragmatically, they are not unaware of the technological delays in many sectors ranging from healthcare, because vaccines are ineffective, to semiconductors. Thus, they should not remain deaf to Joe Biden's pressures.

- ***The Russian alliance does not bring much to China***: China cannot afford to cut off from the Western world to strengthen its ties with Russia. Russia's GDP is only $1.6 trillion, 1.6% of the world total, while the cumulative GDP of OECD countries exceeds $55 trillion. Russia's population is 146 million in 2021, while that of OECD member countries is 1.3 billion. The Russian military budget in 2020, €54 billion, did not represent a tenth of the US budget, €680 billion, and even less of the NATO budget estimated at nearly €1 trillion according to SIPRI statistics in Stockholm. It is true that Russia is rich in raw materials but China has always wanted to diversify its purchases and the infrastructure (gas pipelines) is not very important and costly given the distances.

- ***A lot of pragmatism on the part of companies***: if governments display firm positions on relocations, independence etc, the companies are more pragmatic. Thus, despite the sanctions against Russia and the firmness of the US government, despite some resounding announcements of withdrawal, the majority of companies remain active.

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