

Letter n°81

A global indebtedness difficult to control. Where are we heading? (2)

"There is an infinite amount of hope in the universe ...but not for us." Kafka quoted by George Steiner in "From the Bible to Kafka".

Let's start this Letter with 3 observations and 2 uncertainties:

- ***The grim prospects associated with global public debt:*** after devoting Letter 80 to the evolution of public debt worldwide during this recent period, after observing a doubling of this global public debt since 2011, let's try to project ourselves into the future and note from the outset that there is no foreseeable resolution of this debt. On the contrary, we are inclined to borrow Kafka's words and anticipate a further deterioration of these debt ratios.
- ***Denial cannot constitute a policy:*** denial in the face of the financial situation of states, denial in the face of the costs and implications of aging, denial in the face of ecological risk, denial in the face of deindustrialisation, denial in the face of the Chinese threat.
- ***The four causes behind this pessimism:*** the increase in retirement and healthcare expenses due to demographic aging, or even population decline; the rise in defence budgets, approximately 1% of GDP, motivated by international tensions; the cost of energy transition, 1 to 2% of GDP per year; and the effort required to facilitate the relocation and reindustrialisation of developed countries.

These four causes affect not only China but also the United States, Europe, Japan, and many Asian countries. Others, such as Africa and India, are spared from aging but not from other challenges.

- ***Uncertainty about the extent of worsening budget deficits:*** the cost of these four causes amounts to two to three percentage points of GDP every year, in addition to current budget deficits, with an unknown factor: interest rates, in other words, the cost of debt. In the 2010s, the average annual service of this global public debt, according to Janus Henderson, was 1.4% of GDP, and by 2025, according to their estimates, it could reach 2.8%.
- ***Uncertainty about interest rates:*** it is difficult to make predictions about the evolution of rates, although a decrease in inflation can be anticipated. Will the savings surplus persist? It is uncertain due to aging. Is aging a factor that structurally leads to higher inflation? The debate is ongoing.

In this Letter 81, we will analyse each of the four factors that could exacerbate global public debt.

The rise in defence spending:

Clark, in the excellent book "*The Sleepwalkers*," shows that in 1914, war was not believed to be imminent, but the logic of power in each camp led to it. We may not be at that point, but let's not bury our heads in the sand regarding the Chinese threat. The absence of global leadership is a factor of instability and rivalries.

- ***Defence spending at a record level:***

According to SIPRI, global defence spending amounts to \$2.2 trillion. It increased by 4% in 2022, and companies in the sector, whether listed or not, have greatly benefited from this trend.

This figure is far from insignificant because at the peak of the Cold War, according to S&P Capital, defence spending, in constant terms, did not exceed \$1.5 trillion.

The United States alone spends \$870 billion, which is 40% of the global total, more than the following nine countries combined.

The war in Ukraine has highlighted four deficiencies: the weakness of weapon stockpiles, unpreparedness for war, the need for increased investment against cyberattacks, and greater investment in drones.

As an additional constraint on budgetary balances, many states have decided to increase their defence budget to 2% of GDP in the face of threats.

- ***A European awakening:***

In Europe, the increase in defence spending is a revolution. While in the 1970s, states annually spent 2 to 3% of their GDP on defence, in the past twenty years, this percentage had dropped to an average of 1.5% of GDP.

Today, there is a general commitment to increasing defence budgets, from Poland, with a budget representing 4% of its GDP, to Germany, which was hesitant and reluctant to rearm until the outbreak of war.

France, the only nuclear power in the EU, has announced a plan of €415 billion for the next 7 years, amounting to nearly €60 billion per year.

- ***Increased spending in Asia:***

Japan, whose budget was not supposed to exceed 1% of GDP, is also changing its approach and has announced a budget of \$52 billion, a quarter increase.

China is investing more and more in its defence. Officially, the country spends \$290 billion, a real increase of 75% over the past decade, but in reality, the expenditures are higher. This is not surprising considering the growth of the GDP, but it does not leave the countries in the region indifferent.

- ***An expected escalation of budgets:***

According to The Economist, global defence spending could increase from \$200 billion to \$700 billion per year. The rivalry between China and the United States, combined with the European countries' desire to protect themselves from Russia and harmonise their equipment for common defence, as well as the aspirations of Asian countries such as India, Japan, and Australia to safeguard against the Chinese threat, all contribute to an increase in military expenditures.

In summary, all factors contribute to a rise in military spending, benefiting publicly traded companies in the sector. China seeks to avenge the humiliation of the two Opium Wars and, at the very least, assert itself in the South China Sea. The United States aims to preserve its influence, while other countries wish to avoid bloc politics, play a role in globalisation, without aligning themselves with the West, China, or Russia. As **Bertrand Badie** puts it, this is "*the era of free unions after that of arranged marriages*". A free union, an autonomy that necessitates military budgets.

The rise in expenses related to aging:

The planet is aging rapidly, with the top 15 economies in terms of GDP, except for India, having a fertility rate below the replacement rate of 2.1 children per woman.

People aged 65 and over represent 9% of the global population, but in Japan, it is already 28%, 22% in Germany, 14% in South Korea, and 11% in China. This is in stark contrast to Mali or Kenya, where people aged 65 and over account for only 2%.

The key point is the acceleration of this aging process. In South Korea, by 2045, people aged 65 and over will constitute 36% of the population because the fertility rate does not exceed 1 child per woman. The situation is not much better in Italy, with 1.25 children per woman, or even in the OECD with an average of 1.6.

Retirement benefits used to be relatively inexpensive because people died at a younger age, and in 1945, for example, there were eight active workers for every retiree in France. By 2030, the ratio will be almost 1 active worker for every inactive person, and France is far from being the most critical case.

In many countries, the increase in the number of people aged 65 and over will lead to higher retirement and healthcare expenses as a percentage of GDP, resulting in increased budget deficits and public debt.

Certainly, raising the retirement age is a means to temper the rise in expenses. Japan provides an example with a labour force participation rate of 55% for individuals aged 65-69. However, such a high rate is difficult to imagine in many other countries.

By 2060, according to S&P, retirement expenses are projected to increase by 4.5 percentage points of GDP, and healthcare expenses by 2.7 percentage points. Budget deficits could reach 9% of GDP compared to an estimated 2.4% in 2025°.

The rise in expenses related to relocations and reindustrialisation:

- *The quest for attractiveness:*

Each country has its strengths and weaknesses and must work with them to optimise attractiveness. Among the handicaps, for example, the United Kingdom has suffered from isolation outside the European single market since Brexit. Germany, Spain, and Italy are penalised by demographic decline, while France faces high mandatory levies. Other countries are hindered by the small size of their markets. The list could be more exhaustive, but the challenge is to overcome these weaknesses to attract foreign investors.

- *Deindustrialisation, an evident trend, but with some nuances:*

Let's start by correcting a fairly common misconception. While there has undeniably been deindustrialisation and factory closures in OECD countries, the comparison over time is biased or exaggerated because many industrial companies have outsourced service activities to optimise their core operations. As a result, some jobs have not disappeared but have been reclassified from the industrial sector to the services sector.

Despite this observation, where deindustrialisation has occurred, there has been a replacement of skilled jobs with low-skilled, lower-paid jobs in the services sector, resulting in stagnant wages that adversely affect the middle class.

- *The distinction between reindustrialisation and relocation:*

Reindustrialisation does not fully overlap with relocation. Reindustrialisation aims at positioning in new industries, while relocations are driven by a desire for regained independence.

Reindustrialisation involves investment in future sectors such as green hydrogen, small nuclear power plants, and quantum computing. It is no longer about defending "struggling industries" as it was 30 years ago, but rather about economically necessary and politically justified investments to echo national independence, as many challenges, such as energy transition, water treatment, pharmaceutical industry, and defence, require a competitive industry.

The movement of relocations today responds to a theme shared among major countries, a desire to reduce dependence on China, even though the president of Nvidia recently stated that trade restrictions in China-US relations penalise American companies.

Before the shortages that arose with the Covid crisis, before tensions with China and concerns about supplies, before the invasion of Ukraine and the spotlight on energy dependence, this theme of relocation remained largely theoretical. Since then, it has become a chapter in all political agendas.

A topical example of these developments is seen in Italy, where tensions within Pirelli with its Chinese shareholder, Sinochem, a state-owned company holding a 37% stake, are problematic because representatives of the Chinese Communist Party intend to be involved in all decision-making processes of the group.

- ***Large countries have a competitive advantage in these policies:***

The advantage partly lies in state subsidies for establishment. Leading companies in future sectors are highly sought after and, logically, they drive up the competition when choosing the location for their factories. This can be seen with TSMC in semiconductors, Tesla in electric vehicles, or the selection of sites for gigafactories for batteries.

The American IRA plan, as presented in our various publications, is emblematic of this relocation policy, subsidy policy, and attractiveness policy, and Europe is implementing an equivalent plan.

However, there is a cost from mere intention to implementation. Attracting companies does not happen without subsidies, labour retraining, investments in infrastructure, and tax competitiveness.

The required investments can sometimes be very high. For example, Intel plans to invest \$17 billion in Germany for semiconductors, but it will only create 3,000 jobs with the condition of \$10 billion in government subsidies.

In France, the €54 billion reindustrialisation plan by 2030 aims to promote around ten sectors of excellence, ranging from healthcare to nuclear power, from space to decarbonised hydrogen, from food to transportation, from renewable energy to quantum computing, and to support training for providing qualified personnel to serve these ambitions. The idea for the government is to accompany developments and attract investors in a ratio of 1 to 4 or 5 between public and private funds.

For instance, the gigafactory that opened in northern France, intended to produce 300,000 batteries per year, cost €7.3 billion and received €1.3 billion in public assistance.

In France, significant government support of €2.9 billion was announced for an STMicro factory in the semiconductor industry.

Such subsidies can only be offered by a large state, which means that smaller states are disadvantaged by this policy.

- ***Reindustrialisation should not be synonymous with deglobalisation:***

While relocations can be beneficial for reindustrialising deserted regions and bringing more independence in sectors considered strategically important for national sovereignty, one should not succumb to protectionism, which leads to structural inflation, or to the isolation of political blocs, which leads to tensions. It is also important not to forget the purchasing power gains achieved over the past 30 years by imports from low-cost countries.

- ***The expected consequence of relocations:***

Clearly, the growth of international trade will be hindered by this movement of relocation. This year, the volume growth of trade is expected to barely exceed 1%, while for years this growth has been doubled that of global GDP.

In summary, in this reindustrialisation movement, more than subsidies to a specific company, the primary role of the state is to make a territory or region attractive and create favourable conditions for investment, including infrastructure, taxation, and the training of qualified personnel.

Increase in expenses related to the energy transition:

The climate issue is a matter of civilization. The decline of the Mayan cities from 700 AD onwards, such as Tikal, later Palenque and Copan, was accompanied by episodes of drought. Further north, Chichén Itzá in the Yucatan plain experienced a decline in the 11th century following a drought.

Liberalism has enabled the creation of great wealth and lifted hundreds of millions of people out of poverty, but our ecosystem is degraded.

The main weakness of liberalism has been the excessive exploitation of nature at a too low cost. Therefore, new taxes are needed to make polluting goods more expensive. This is the ambition associated with the carbon tax.

- ***Additional costs without productivity gains:***

The energy transition is costly because it requires the depreciation of assets in fossil fuels and necessitates investments in renewable energy or energy efficiency, without generating productivity gains. Among the numerous reports published on this topic, there is a convergence to estimate the investment cost for states at 2% of GDP per year, in the form of subsidies or co-investments.

- ***A carbon tax with limited effects:***

To limit the increase in debt, states will have to mobilise savings.

One of the solutions to contribute to the financing of this transition lies in the widespread implementation of a carbon tax. It has the dual advantage of discouraging the use of polluting consumption patterns and partially financing the transition. The EU, for example, will impose a tax of €45 per tonne of CO₂ on natural gas, oil, and gasoline starting from 2027.

However, overall, according to the World Bank, various carbon taxes worldwide will generate no more than \$100 billion in 2023, which is minuscule compared to the investments required for the transition.

- ***Necessary government subsidies:***

Encouraging households to make efforts in building insulation makes a lot of sense because over one-third of emissions come from this sector. However, many households cannot bear the cost. Incidentally, financing the energy transition in buildings will deplete real estate-rich pension funds.

Promoting the acquisition of electric vehicles makes sense because over one-fifth of EU emissions come from the transportation sector. However, once again, the significant investments underway or planned in batteries cannot happen without subsidies.

In Germany, a €50 billion plan has been announced to assist industries in accelerating their energy transition.

In France, according to the think tank France Stratégie, the energy transition will cost €66 billion annually over the next seven years, with €15 billion borne by households, €15 billion borne by businesses, and the remainder covered by the government. This will result in a 10-point increase in the debt-to-GDP ratio during that period.

Conclusion: *“An abyss is right there close to us. We poets dream on the edge, you statesmen, you sleep in it.” Victor Hugo in Post-scriptum de ma vie.*

In a provisional conclusion on this vast subject, seven points emerge that resonate with Victor Hugo's words:

- ***The tax bias:*** it is difficult to address. Even though the wealthiest 10% account for nearly half of global greenhouse gas emissions, specific taxation would pose various problems.
- ***The patrimonial aspect:*** in the face of debt, there are assets, and they have significantly increased in recent decades. According to McKinsey studies, the global stock of wealth has increased by \$160 trillion since the year 2000, which is equivalent to about two years of GDP. This growth is partly due to economic expansion and largely driven by asset price appreciation, especially in around 50 cities worldwide, facilitated by significant liquidity injections. Today, global assets represent 600% of global GDP, compared to 470% in the year 2000.

Clearly, this asset valuation could increase with economic growth and productivity gains, but it could also decline if stock markets and real estate assets were to experience a downturn. In that case, the asset-to-debt ratio could deteriorate.

- **The financial constraint:** the message is clear, states cannot indefinitely allow their debt to spiral out of control, risking investor confidence.
- **The monetary equation:** if interest rates exceed economic growth rates, the burden of debt will quickly become unsustainable. However, due to the aging population, slower technological progress, modest productivity gains, decreased corporate investment, increased debt levels, reduced competition and innovation spurred by the concentration of companies and the proliferation of monopolies in many sectors, global growth is slowing.
- **Budgetary constraints:** defence, aging, healthcare, and energy transition are key issues, but states cannot sacrifice spending on education or other essential budgets. Certainly, some states can and should save on operating expenses, but that will not be enough to offset new expenditures.

In the long run, as states are unable to meet all needs, they may entrust education and healthcare services to the private sector, or even partially outsource defence to private militias, and perhaps choose to reserve the welfare state solely for the poorest.

- **The industrial challenge:** the necessary industrial renaissance is key to defending the middle class, addressing the climate transition, and gaining independence from China.
- **The societal challenge:** in the past, we sacrificed for future generations, but today it is the opposite. For example, home loans, which in the past were for five years, now extend across a generation, fuelling the inflation of real estate prices. Thus, there is a rent being paid to future generations who are constantly having to take on more debt.

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