Letter n°87

The winners and losers of reindustrialisation.

"I would rather see finance less proud and industry more content" Churchill.

This quote from Churchill in 1925, nearly a century ago, sums up the current climate well because many states would like their industry to be more prosperous. This industry, which was somewhat sacrificed at the end of the 20th century, is making a strong comeback in political discourse and economic initiatives; we can thus speak of reindustrialisation.

- From globalisation...

In the late 1990s, there was a trend of deindustrialisation in developed countries, with the closure of numerous industrial sites and the relocation of factories to low-cost emerging countries, especially China. The idea, advocated by some at the time, was to keep research centres and so-called value-added jobs in Western countries, optimise production costs, and access new growth markets.

Globalisation helped reduce the number of global poor from 1.8 billion in 1990 to 650 million in 2018.

More specifically, this wave of globalisation enabled hundreds of millions of Chinese people to escape poverty, allowed the Chinese economy to achieve an average annual growth rate of over 10%, and facilitated Chinese companies in acquiring Western technology, leading them to become global leaders or formidable competitors.

The flip side of the coin was a relative impoverishment of the middle classes in developed countries, stagnant wages, difficulties in transitioning, the decline of certain old industrial regions, and, in these same countries, a weakening of democracy with a rise in populism.

- ... to relocations

In recent years, in developed countries, we have witnessed a symmetrical movement, a swing back, a rise in protectionism, and a proliferation of state incentives for the repatriation of activities considered strategic or for the development of promising industries.

Faced with this fundamental shift, stock market investors must consider the question of winners and losers. Which countries? Which sectors? Which companies?

In this letter 87, we will see that a handful of developed countries will benefit from reindustrialisation, and some emerging countries, such as Vietnam, Mexico, Bangladesh, and also India, will take advantage of a relocation movement. All of this will come at the expense of China, whose structural growth is simultaneously impacted by a declining population and slowing productivity gains, and whose cyclical growth is hindered by the real estate crisis and high levels of indebtedness.

Benefits for the wealthiest countries:

Not only do large countries strive to collect tax revenues by now imposing taxes on GAFAM companies, but they also multiply their plans and redouble their efforts to increase the competitiveness and attractiveness of their territories. In this game, the wealthiest countries, in order of the United States, Japan, Germany, and

France, will be the winners because their financial capacity to subsidise and encourage large multinational corporations to establish production sites is unparalleled compared to smaller countries.

United States:

The United States - frustrated by the loss of over 5 million jobs in the industry over the past 30 years, even though productivity gains explain most of these losses and only 1/6th of the job loss can be attributed to Chinese competition - intends to revive its industrial bases.

In 2018, Donald Trump imposed 25% tariffs on a number of Chinese imports. In 2019, the list of sanctioned products was expanded, and in 2022, Biden extended sanctions to Chinese telecommunications operators, while also imposing restrictions on direct investments by American companies in China in certain sensitive technologies.

The United States does not intend to merely lead the world in patent filings, display a high research budget of 3.5% of GDP, or offer the most liquid financial markets to fuel numerous start-ups. They want to renovate their infrastructure, accelerate the energy transition, and strengthen their competitive position in semiconductors.

In response to each of these themes, Biden has introduced plans with very substantial financial resources made available to companies.

The infrastructure plan represents $1.2 trillion, the Chips Act for semiconductors provides $50 billion in subsidies, and the plan for the energy transition, IRA, offers $370 billion. Together, this represents the most ambitious program initiated by the government since Franklin Roosevelt.

Subsidies and tax incentives are necessary because production costs are higher than in many other countries. The Taiwanese company TSMC agreed to invest in Arizona, but it required compensating for production costs that were 50% higher than in Taiwan. Examples in this direction could be multiplied.

We will appreciate the results in a few years, but in the meantime, in 2022, the United States' trade deficit with China reached $380 billion.

Japan:

The country has a $150 billion plan for the promotion of green technologies. Similarly, Japan has significant ambitions to regain the lost pre-eminence in semiconductors and intends to encourage Japanese companies to leave China and relocate locally.

Europe:

According to the European Commission, €740 billion in state aid has been announced since March 2022, with 48% coming from Germany, 22% from France, and only 7% from Italy.

Germany has announced a €7 billion tax incentive plan to boost the economy and support modernisation. Over four years, the plan will provide €32 billion in tax relief. These measures are combined with a €200 billion plan, recently increased, to assist the industry.

France is also not lagging behind and has adopted a €100 billion plan by 2030 to support the industry.

These are advantages that smaller countries are unlikely to offer. They create competition distortions and serve as indicators of Germany and France's return to competitiveness on the international stage.

- The example of semiconductors:

In the semiconductor sector alone, nearly €100 billion in projects have been identified in Europe in recent months, utilising a portion of the European Chips Act's €43 billion fund. The goal is to double Europe's global market share in semiconductors to 20%.

Germany, with its strength, has offered €5 billion in subsidies to TSMC for the establishment of a €10 billion factory in Saxony. One month prior, Germany had signed an agreement with Intel for the establishment of two semiconductor plants specialising in advanced chips less than 2 nanometres in size, with a total investment of €30 billion.

France has secured a €7.5 billion investment from ST Micro, including €2.9 billion in subsidies. Alongside semiconductor projects, there are numerous projects in the battery sector, and state subsidies, primarily from Germany, the United Kingdom, Hungary, Spain, and France, are competing to attract investors.

While these subsidies bring potential risks of overcapacity, in the meantime, they are also criticised by poorer countries.

- The example of the automobile market:

The European automobile sector is a key industry. It relies on Chinese components, but it is also the largest industrial sector in the EU, accounting for 6% of jobs.

For a long time, European authorities were accused of being overly idealistic or, at the very least, focusing only on competition and the open access to the European market, without considering the aid measures that international rivals of European companies could benefit from.

European automotive manufacturers, given the priority set for the development of electric vehicles, are concerned about Chinese competition.

Currently, Europeans pay a 25% tariff to enter China, while the Chinese pay 10% to enter Europe and 27.5% to access the American market.

The rapid rise of the Chinese automobile industry in international markets is impressive. It is the result of years of efforts to increase competitiveness, multiple subsidies provided by the Chinese government to local authorities for the purchase of electric vehicles, and the requirement for Chinese automakers to equip their vehicles with batteries made in China.

The numbers are telling: in 2021, China imported twice as many automobiles as it exported, and by 2023, it had become the largest exporter, surpassing Japan with $35 billion in sales compared to $21 billion in imports. In the Chinese market, Chinese automaker BYD is now the top player ahead of VW.

The dominance of Chinese companies in the electric battery sector is such that they control nearly 80% of the global market, with six of the top ten global groups. CATL is the largest with 37% of the global market, and BYD holds 13% of the market. The only solution seen to address this situation is the establishment of Chinese factories in Europe.

- The example of renewable energy:

The European Net Zero Industry Act aims to support and simplify the development of green technologies. It envisions a doubling of the share of renewable energy in European consumption by 2030, reaching at least 42%.

The situation is quite similar to that of electric batteries, with a similar dominance by Chinese players. Over the years, through subsidies, Chinese companies have become highly competitive, leading to the disappearance of many European companies. This holds true for wind energy as well as for solar panels.

Challenges for small countries and China:

Small countries, penalised:

The term "small countries" is not used pejoratively here. It simply refers to financial capacity, market size, and possibly geographic location.

For several decades, small countries, like Ireland, have been able to offer tax attractiveness, host the regional headquarters of many multinational corporations, and benefit from high growth and prosperity. As we have previously analysed in a previous letter, the sought-after global tax harmonisation, facilitated by the implementation of a minimum tax rate, is changing the landscape.

In addition to this, there are now challenges related to reindustrialisation. Small countries are at a disadvantage because they cannot provide sufficient subsidies to attract large industrial projects.

Obstacles to Chinese penetration:

Chinese authorities are not mistaken and are displeased with the proliferation of measures that complicate, restrict, or even close access to major Western markets.

- Obstacles posed by the United States:

First, there were the American sanctions initiated by Donald Trump, which were maintained and even strengthened by Biden.

As a result, in the first six months of the year, China accounted for 13% of US imports compared to 21.6% in 2017. Nevertheless, trade has been developed with countries in Southeast Asia.

- Obstacles posed by Europe:

Now there is the awakening of European consciousness, a much more coordinated approach among member countries, and in many sectors, the study or announcement of protective measures. The most recent example is in the automobile industry.

At the same time, Italy is expected to withdraw from the Silk Roads. Chinese investments in Italy amounted to 650 million in 2019, but they dropped to 20 million in 2020 and 33 million in 2021.

Retaliatory measures:

As the world's second-largest economy and the leading exporter with an 18% market share, China is not defenceless and has numerous tools to counter Western initiatives.

- The attractiveness of its market:

Apple generates 20% of its sales in China, BMW one-third, Volkswagen nearly 40%, ... We could cite many examples of companies for which the Chinese market is an essential component of their development.

Even though the projected GDP growth rate is no longer 10% per year but 3%, it is often still enviable for multinational corporations facing stagnation in growth in Japan or the low growth of European countries. The Chinese market, even with a declining population, still comprises 1.4 billion consumers.

The Chinese are not hesitant to wave the flag of market closure. Undoubtedly, the Western multinational companies mentioned above would experience a substantial loss in market valuation if relations were to deteriorate.

The Chinese are also not hesitant to promote local companies to compete with Western ones.

- The potential arsenal of retaliatory measures:

China produces 50%, and in some cases, 80% of rare earth metals, which are essential for semiconductor manufacturing. While there are mines in Western countries, their production poses ecological problems, often requires a significant amount of water, and cannot be quickly scaled up.

China also serves as a subcontractor and supplier of essential components for many Western companies. For example, China is Germany's top supplier, providing 200 billion euros worth of goods each year. This includes a wide range of electrical components, telecommunications equipment, and electronic goods...

When displeased with American sanctions, the Chinese are not hesitant to block merger and acquisition deals, such as Intel's attempted purchase of Towel Semiconductor for $5.2 billion, which was recently halted.

Conclusion: "***Help yourself and Heaven will help you too" La Fontaine in The Carter in The Mire.***

The final sentence of this famous fable by La Fontaine encapsulates the creed of Western countries when it comes to industry: a significant amount of aid is provided to companies to encourage them to relocate, to open factories to create a dynamic that can raise potential growth. However, let's consider 9 points of conclusion to qualify this maxim:

- ***Reindustrialisation is a commendable ambition, but no major power will ever be entirely self-sufficient,*** or if so, at a very high cost. Developments in robotics and artificial intelligence may mitigate the handicap of labour costs, but often, diversifying sources of supply should be prioritised over relocating.

- ***Reindustrialisation represents a political ambition that is often financially challenging for firms to achieve.*** Subsidies and tax incentives are a means to reconcile the goals of states with the constraints of companies, but, as many reports highlight, this can sometimes come at the expense of optimal capital allocation, potentially harming global economic growth. In many countries, the quality of the workforce or the quality of infrastructure is far inferior to that of China.

- ***The Western mistake was to admit China to the WTO in 2001 without banning public subsidies*** to businesses and without requiring the opening of Chinese public markets to Western companies. In 1990, China accounted for less than 3% of global exports; today, it's 18%. Since 2001, China has been able to establish itself as a global leader in many sectors and eliminate competition from numerous Western industrial companies.

- ***The slowdown in the growth of international trade dates back to 2012*** because, simultaneously with the structural slowdown of global economic growth, there has been an increase in trade barriers. In 2010, the IMF counted 273 such barriers, but by 2022, there were 2,800. While trade growth was twice that of global GDP before 2008, it has since been in line with GDP growth. International trade as a percentage of global GDP, which rose from 31% in 1975 to 61% in 2008, fell to 57% of global GDP in 2021.

- ***Reindustrialisation in developed countries will harm emerging nations*** and thus exacerbate wealth disparities in favour of the West.

- ***There is not necessarily alignment between the political goals of states to be less dependent on China and the strategic interests of multinational firms*** eager to preserve access to the Chinese market. Tesla is very happy to produce half of its vehicles in China, and Airbus is installing a second assembly line in the country.

- ***Tariffs are ultimately borne by the consumer***, whose purchasing power is thus diminished. Let us never forget to emphasise this.

- ***Current political tensions between China and the United States are economically challenging to manage*** because American firms are heavily present in China, many Chinese companies are listed on the Nasdaq, and China is the largest customer and supplier to the United States, with trade between the two countries exceeding $700 billion. This is quite different from the time of the Cold War. Back then, tensions between the United States and the USSR had little economic impact because trade relations between the two countries were minimal.

- ***The ties between Americans and Chinese are less strained than expected.*** Americans buy more from Mexico and Vietnam and less from China, but these countries trade more with China, and Chinese companies have invested significantly in these nations.

Certainly, China's economic difficulties partly result from American sanctions, but Xi's ideological hardening, the priority given to order over economic growth, the primacy of state-owned enterprises, and measures against tech entrepreneurs are all contributing factors to the slowdown.

Geneva, 21 September 2023

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