

Deglobalization...?

By

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The global economy has experienced a golden era over the past 40 years: an annual growth of 5.5% (3% excluding inflation²), a total shareholder return (TSR) of 8% per year for major global stock markets, inflation dropping from 12% to 1%³, and some major countries emerging from poverty and reaching average living standards comparable to those of Europe or the United States two decades ago.

Globalization has been a key driver of this growth, with several concomitant levers: the lowering of customs barriers (cut by more than half in mature markets and by over five times in fast-growing economies), China's entry into the modern global economy and international trade under Deng Xiaoping following the example of Singapore, the development of distribution chains in Western countries capable of interacting with distant suppliers in low factor cost countries, the relocation of low value-added industrial activities, as production chains become increasingly sophisticated, and finally, the development of major markets in Asia, induced by these trends, offering new outlets for Western companies.

These various levers enabled virtuous growth (excluding inflation, 50% of growth coming from increased productivity of production factors⁴) with low inflation (2.5% per annum⁵) and with the global trade rising from 40% to 60%⁶ of the world GDP over the period.

Ricardo's theory of comparative advantage prevailed – for a while.

Today, this cycle is being called into question: it is rejected by part of the Western middle classes, who benefited from it in the first place; industries that were unable to adapt are weakened in certain Western countries; the energy transition calls into question polluting short- and long-distance transportation; certain political or geopolitical positions favor control of territory (populations and goods) over openness and fluidity of resources.

Are we entering a cycle of economic deglobalization?

Realities and limitations

82% of annual patents are filed in five countries (China, USA, Japan, Korea, Germany)⁷; 64% of the world's industrial production is concentrated in six countries (China, USA, Japan, Germany, India, Korea) (29% in China alone); 72% of energy sources come from ten countries (USA, Russia, China, Australia, Venezuela, Iran, Saudi Arabia...)⁸; 56% of agricultural land is in ten countries (China, USA, Brazil, Russia, Kazakhstan⁹...); rare minerals are each

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² Figures for the 1981-2021 period.

³ 1% in 2015, rising to 2% in 2019 and 3% in 2021.

⁴ Increased factor productivity and population growth.

⁵ 2.5% per year over 2011-2021.

⁶ 60% in 2014 (56% in 2019 and 52% in 2020).

⁷ Data for 2019.

⁸ USA, Russia, China, Australia, Venezuela, Iran, Saudi Arabia, India, Canada and Qatar (2018 data).

⁹ China, USA, Australia, Brazil, Russia, Kazakhstan, Europe, India, Saudi Arabia and Argentina (2020 data).

concentrated in one or two countries (70% of lithium comes from Australia and Chile¹⁰; 67% of cobalt from Congo; 52% of rare earths from China).

At the microeconomic level too, the dynamics of comparative advantage had had great effect: 73% of semiconductors are manufactured in four countries (Taiwan, Korea, Japan and China); 75% of automobiles are produced by companies in six countries (China, USA, Japan, Germany...); 55% of nitrogen fertilizers are produced in four countries (China, USA, India, Russia); almost 50% of the digital economy comes from American¹¹ and Chinese leaders¹² in the field; 80% of luxury brands are owned by French and Italian companies; 50% of medical supplies and equipment are manufactured in China.

As major R&D or service centers, design or industrial production steps, sources of energy or raw materials, arable land... – but also leaders per business – are each concentrated and located for the most part in different countries, *exchanges will continue. No significant deglobalization is possible between countries in the medium term.*

What's more, in many businesses, the scale effects associated with modern industrial processes would be insufficient in a purely national context (except for continental states such as the USA and China). Such fragmentation would entail a massive economic shock and major additional costs incompatible with any significant medium-term growth.

Can we imagine *a more limited* fragmentation between a few very large blocs, given their size and self-sufficiency in terms of energy sources and raw materials, workforces, industries, scale effects and know-how, with the bulk of trade taking place within these blocs rather than between them?

Such fragmentation *would be less efficient than globalization but feasible.* In such a scenario, five to six major economic blocs (North America, China, Europe, India with Southeast Asia...), complemented by resource-rich regions like the Middle East, would form the new global economic structure. Each of these blocs already has a GDP equivalent to *the entire world* in 1995. While the consequences would include higher costs and some economic inefficiencies, the overall disruption would be far less severe than a complete retreat into national economies.

Compared to the USA and China, Europe would have the most to lose in such a scenario: no energy independence in the next 30 years (even while taking into account investments in renewable energies and nuclear power), no strategic raw materials, growing industrial weakness, technological gap, no world leaders in the industries of the future, and low resource fluidity.

Costs and inflation risks

Globalization has concentrated industries in regions with the greatest scale effects, reducing costs and optimizing supply chains. Reversing this trend would be difficult, expensive and time-consuming.

For households, the impact would be severe. Between 1960 and 2021, the average French household's annual spending rose from €1,900 to €40,000 (adjusted for inflation), while the share of expenditures on food and clothing fell from 43% to 21%. Expenditure on communications, media and leisure rose from 8% to 12%. Spending on housing rose from 20% to 33%. This shift was largely enabled by globalization. A return to localized production would cause massive inflation, making current consumption patterns unsustainable.

For businesses, the challenge is even greater. A modern iPhone involves 17 production stages across 20 countries, optimizing cost, functionality, and technological advancement. If

¹⁰ 2020 data.

¹¹ Google, Apple, Facebook, Amazon and Microsoft.

¹² Alibaba, Baidu, Tencent, JD.com, Meituan, Bytedance, Xiaomi and PDD.

production were fully localized within a single country (e.g., the United States), costs would triple, drastically shrinking the potential market.

Impact on the energy transition

Globalization has gone hand in hand with a growing supply and demand for energy linked to economic growth, in particular oil (the energy used for short- and medium-distance road transport, long-distance sea and air transportation...), gas (the energy used for heating and agricultural fertilizers), and coal (the energy used for electricity in Germany, Australia, China, India, Indonesia...). Today, these fuels still represent 85% of the global energy mix, with nuclear power at 10% and renewables at just 5% despite two decades of investment.

Partial deglobalization (with fragmentation between a few major economic blocs) could slightly reduce fossil fuel demand: lower global growth, relocation of some production in countries with lower fossil fuel consumption¹³; lower consumption linked to intercontinental transportation, (which is only 3% of total CO2 emissions). However, it would also disrupt the renewable energy transition. Currently, 90% of the world's solar panel production is in China. Most growing leaders in wind turbine production are also Chinese and Indian, and they strongly threaten European players. 65% of batteries for electric vehicles are produced in China. A reduction in international trade would increase the cost of the energy transition in Europe and the United States.

Moreover, in a multipolar world, there would be a high probability that major economic blocs would pursue divergent energy and climate policies, potentially making it impossible to have an effective energy transition globally (*without oil, China may power its electric cars with coal-based power plants*¹⁴).

This scenario presents a triple threat: slower economic growth, higher inflation, and continued high carbon emissions. Even if it materializes in the short term, it is therefore unlikely to be last.

How to adapt?

Deglobalization – even if only partial – is not desirable. But it could happen because it is not unrealistic if it happens in the form of a few economic blocs.

For companies, lower visibility on the evolution of international trade necessitates to mitigate risks and increase costs accordingly.

Market risks

In Asia, whether it be for industrials or for consumer goods, China is an irreplaceable market given its size. For some Western companies, it accounts for 50% of sales and 70% of stock market value. However, India (which follows the trajectory of China with a 20-year lag), Indonesia, and ASEAN countries could provide alternative growth markets in the medium term.

Overall, some countries (strong exporters, or strong importers, or both) will suffer more than others, and their markets will become less attractive. (*Germany, Japan and Korea are the three major countries that would have the most to lose from strong and rapid deglobalization: their domestic markets are too small for their industries, they have no energy autonomy, and their economies depend heavily on exports and imports.*)

¹³ With the possible additional economic costs.

¹⁴ Growing share of electric cars, powered by the electricity network operating at 63% from coal-fired power stations.

For a company, choosing countries and their weighting therefore becomes a critical issue that goes beyond the specific attractiveness of each one of them individually. In the short term, the diversification and reallocation of target markets will increase companies' sales and distribution costs. This trend may accentuate the polarization of certain industries, with, on the one hand, major leaders remaining "international", as they are able to spread out the costs and risks of internationalization given their size and competitiveness, and on the other hand, smaller specialists with higher geographical focus and with high differentiation. Intermediate players risk being wiped out.

Supply and production risks

In production chains, duplicating internal production sites or suppliers at certain steps to reduce geographical risk is an insurance policy. But in some industries, this option quickly proves limited; there are ultimately few industrial countries that combine both a skilled workforce adapted to complex production processes with close and deep subcontracting networks for different sources of components or intermediate modules.

The other option is to build autonomous production chains within a large geographical bloc addressing target markets. This would reduce efficiency for a company but increases resilience in the event of increased customs barriers and the return of quotas or trade restrictions, especially since these blocs are often homogenous monetary zones.

In both cases, the reduction in risk will be accompanied by an increase in costs.

This increase will not translate into price increases equally for the different players. Added to increases in raw materials and wage inflation, it leads to a risk of potential reduction or increased volatility of margins.

Low visibility, increased volatility

A risk of partial deglobalization exists, in a limited way, with possible fluctuations in the next ten years and significant adaptation costs.

Where can resources be best allocated to continue growing while maintaining profitability and the level of risk? What is the maximum acceptable level of risk given the size and financial room for maneuver of the company? Crash tests, as in banks, can help to better rebalance market and supply chain portfolios based on different scenarios. The risk of deglobalization adds a variable to the strategic equation.

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Estin & Co is an international strategy consulting firm, with offices in Paris, London, Zurich, New York and Shanghai. The company assists senior executives of major European, North American and Asian corporations with their growth strategies, and managers of private equity firms with the analysis and valuation of their investments.

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