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CHINA-US: THE BATTLE IS JUST BEGINNING

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Philippe Waechter
Chief Economist

Donald Trump's threats to world trade are a desperate attempt from the US to maintain the country's world economic leadership. The most dramatic shift over the past 20 years has taken place in China, as the country has displayed stellar growth and now accounts for an increasingly large percentage of the world economy.

China has been one of the big winners from globalization, as citizens have enjoyed an impressive surge in income to the detriment of the middle and lower classes in developed markets, as shown by Branko Milanovic's famous elephant chart. This chart also goes a long way to explaining recent political events in western countries: the middle classes across the board have ended up in a more unstable situation than 10 or 20 years ago, and this has major consequences for the way they vote.

The industrial momentum that very swiftly pushes up income is now the preserve of Asia, and China in particular. Industrial output across the US, Japan and Europe – the three major areas that drove world growth after the Second World War – has stagnated over the past ten years, while figures in Asia (excluding Japan) have doubled. The "Made in China 2025" plan seeks to further accelerate this shift.

This contrasting industrial momentum now comes firmly down on the side of Asia and acts as the focus for Trump's trade measures against China. Output is no longer increasing in western countries, but rather in Asia, driving the region's catch-up trend and reducing developed countries' headway. The US is seeing its leadership diminish, while at the same time the situation also raises major challenges for Europe, although it has not taken the same aggressive course of action as the White House. Furthermore, the industrial revival in developed countries often referred to as "Industry 4.0" only seems to involve the substitution of existing production, rather than a true jump in production volumes. For the moment, this so-called revival is not sufficient to point to a reversal in the aforementioned trend towards the location of production in Asian countries.

HISTORY CAN TEACH US MANY LESSONS

During the first period of globalization from the end of the 19th century until 1914, goods were traded and capital was exchanged, but the location of production did not change. When this period of growth ended with the First World War, any one country's dependence on the rest of the world was primarily restricted to colony countries. But in today's world, a large portion of industrialized countries' needs are met by emerging countries, particularly Asia and China. This is why today's situation is different and why a similar type of de-globalization to the situation witnessed in 1914 looks impossible, or at least very different, in our current world.

So there is a certain degree of determinism in the changes we are witnessing today, unless we settle for massive turmoil that would be destructive for all concerned.

Europe and Asia at the start of the 19th century

The History of the world involves parallel growth in Asia and Europe. China was very powerful during the Qing dynasty, while Europe was the major western heavyweight. Each of the two areas enjoyed buoyant growth until the start of the 19th century. Then Europe experienced a period of prosperity with the industrial revolution in Great Britain, which spread to the rest of Europe, while China did not experience the same acceleration in its history. Europe has therefore taken the lead since the 19th century, which subsequently spread to the US.

Features of Europe
Fernand Braudel studied Europe during this period since the Middle Ages at great length and his research is very useful in providing some insight into the past, as well as setting out the events we can expect for the future.

The concept of the world-economy model described by Braudel helps identify the different stages in the history of Europe and its development on a timescale and outline the consequences that are shared across each of these periods.

The history of Europe is characterized by a series of developments in well-defined geographical stages. The center of European growth shifted from Northern Italy in the 12th century to London in the 18th century. The European economy gradually moved north from Italy in the 13th century with the Champagne fairs before converging towards Flanders and Amsterdam.

The key feature of these times when one region dominated Europe was that the dominant region was an innovation leader, it controlled trade and also dominated financially, thereby creating a hegemonic situation over a long period of time.

The last stage in this process was the migration towards the US in the first part of the 20th century, as US innovations, from the washing machine to the computer, spread across the world throughout the entire post-war period while at the same time the dollar's domination was unrivalled.

China's divergence
Asia saw a period of robust growth until 1820 before we witnessed a divergence between the region's trends and Europe, particularly Great Britain. Asia, and China in particular, encountered a period of relative economic decline after the start of the 19th century. While Europe was in the throes of the industrial revolution, which reasserted its power, China failed to embark on the same path. The Qing dynasty was gradually weakened by this situation until it had to stand down in 1912 with the abdication of the last emperor, Puyi, who left the Forbidden City under pressure from the angry mobs disgruntled by their economic situation.

The reasons behind this divergence

A number of researchers have looked into this divergence and the most convincing work highlights the British economy's ability to build up capital, unlike the situation observed in China. The pace of production in Britain at the time was heavily influenced by the accumulation of productive capital, while in China it was more dependent on labor: in Britain, increased production was a result of the accumulation of more productive wealth, while in China it involved the addition of more workers. This divergence between intensive productivity in Europe and extensive productivity in China lies at the very heart of the growth process on the Old Continent. Europe moved forward to meet Schumpeter and creative destruction, while China stuck with Adam Smith and the importance of the extent of the market.

CHINA'S NEW CLOTHES

After the political watershed triggered by the arrival of Deng Xiaoping, China enjoyed a fresh surge in growth. Capital accumulation gradually became a key factor in the country's expansion. Deng Xiaoping's reforms drove robust momentum that focused on investment in productive capacity and exports. This process enjoyed a fast acceleration when China joined the WTO in December 2001 and the country is now accumulating capital to make up part of the lag it has built up over the years. This was visible recently with the 2009 stimulus plan, when corporate lending was encouraged to promote investment, leading to both the creation of hefty surplus capacity in industry but also excessive corporate debt. Managing these excesses lies at the center of current Chinese monetary policy.

China's economic policy has been much more focused on the domestic market since 2011. Investment remains a key plank in the Chinese growth strategy, as capital accumulation is vital to the growth process, but the focus on the development of the domestic market avoids the extremes of the past.

The labor component in Chinese production is still vital, but rather than focusing exclusively on the size of the working population, we have been witnessing an improvement in the country's human capital for the past several years, as the country seeks to develop training and innovation capabilities within the economy. The Chinese economy is moving from Smith to Schumpeter… and this revolution is shaping the entire world economy.

A NEW WORLD ORDER

Asian and western economies developed on parallel tracks for a long time, but from the 19th century, Europe gained the upper hand with its industrial revolution. The continent's lead lasted for almost two centuries but this paradigm is now on shaky ground.

After moving forward on parallel tracks as we described, the two worlds' paths are now merging, and China is taking the lead, as its innovation and growth capabilities change the rules of the world economy. This is a major watershed.

This breakpoint will have a number of consequences.

The first, which we are already witnessing, is China's ability to take center stage as the major contributor to world growth. The size of the Chinese economy and its continued robust pace of growth will sustain this momentum, giving the country the wherewithal to influence all countries worldwide. This will remain the case even when the country's growth, more reliant on services than industry, sees a slowdown to a more pedestrian pace in five to ten years' time.

This direct economic impact began in the middle of the first decade of the 2000s when Richard Freeman predicted the effects on wages of competition from China's arrival on the world labor market, as it sent the supply of labor soaring on a sustainable basis.

The second is that this growth momentum is set to step up a pace with the "Made in China 2025" program, which seeks to further extend China's supremacy in industry and in the disruptive innovation required to implement the initiative.

The third is the implementation of the "Belt and Road Initiative" with the aim of forging strong ties between China and its trading partners… although China will be in charge.

The fourth consequence is the implication of a rebalancing in Chinese growth. This will further promote the expansion of the Chinese financial sector as social institutions and savings establishments will bring a new dimension. This will drive fresh financial momentum affording China even greater power. The question now is whether the newly powerful China will follow the rules defined by the western nations.

The fifth consequence is that the Chinese banking system will need to share its risk, so China will clearly become a major participant on the international arena.

Sixth, the renminbi could become the main currency in the future, underpinning the leading world economy and supporting a vast and powerful financial and banking system. The dollar would then undergo severe competition.

Lastly, this new world balance would mean strong political power for China, which would obviously set it on course for direct confrontation with the US.

Risks of tensions

This situation will clearly affect the entire international community – the world political, economic and financial balance will be completely and lastingly upended, and the US will be one of the most affected. The White House's moves on international trade look very much like a reaction to concerns on this shifting situation, and can be interpreted as a reaction to an environment that is now beyond the country's control. The scales are tipping towards the Pacific and the balance of power seems to be moving towards China, judging by the various points we have mentioned.

It is worth making two final points.

Firstly, just like in each stage of the world-economy, the shift from one phase to another is always fraught with conflict. This means that during the transition period, there will be severe tensions as the world economy rejigs once more. In this respect, globalization may evolve but it cannot be reversed as the west relies heavily on electronic products manufactured in Asia and China.

The flipside of this is domestic turmoil, as we are seeing a growing tendency towards a non-cooperative international approach and the ensuing nationalist political choices, which safeguard local interests and reject greater integration. These changes run contrary to a more rational cooperative and coordinated approach between nations, as outlined by Macron in his speech on Europe at the Sorbonne on September 26, 2017. But the reality of the situation is that Donald Trump was elected President, the UK people voted for Brexit and more recently Italy voted in a populist government that is hostile to Europe and its institutions. Are these the signs of an old world looking for a way back onto a path that no longer exists? There is a danger that the old world will fight back fiercely during this transition period. But in the current situation, Europe lacks unity and the decisive strategy it needs to hold stronger sway in the world. Without giving in to determinism, there is every chance that this century will be more Chinese than European or American.

The second point involves a more recent event. During the recent G7 summit in Canada on June 8 and 9, Trump made it very clear to the G6 that he didn't much care for their opinion. He looked very clearly towards the Pacific and relationships on that side of the world rather than towards the Atlantic and Europe. So Europe must stand united if it is to hold its own. The continent will not play the lead role in the current shift in power, but its nations can keep the impact to a minimum if they join forces. The European Council meeting at the end of June to set a new European framework will therefore be absolutely vital.

We stand at a watershed moment in history as a new landscape is emerging that is very different to the old one. We are witnessing the first unification of the world economy, driven by China, which is already creating some tough competition for the US and forcing the White House to consider a more aggressive strategy to try to safeguard the country's leadership position. I do not think that these protectionist moves will have a positive impact on US growth, but they will heighten tensions with China. The world is becoming a more unstable place, and this is the key point to bear in mind.