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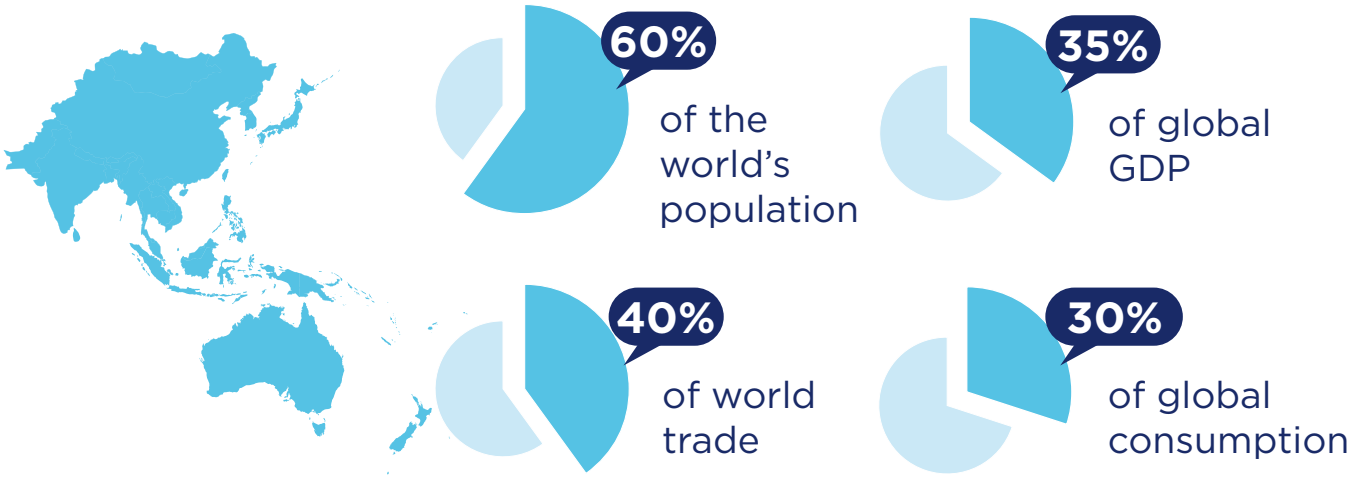
The United States, Europe and China: Different Now, But Changing Again

Asia-Pacific region and the world



When we issued our first report on the transatlantic economy almost two decades ago, the world was a simpler place. Global commercial ties rested squarely on the shoulders of the United States and Europe. Asia, collectively, was an important node of the global economy, but more or less followed the rule-setting global standards of the transatlantic partnership. At the time, Asia's three largest economies – Japan, China and India – did not pull much global weight. Japan's economy was entering yet another "lost decade." China's global integration was shallow and underdeveloped. India remained too poor to cause global ripples. The transatlantic partnership led. The rest of the world, Asia included, followed.

Two decades on, things have changed. The Asia-Pacific region, which accounts for more than 60% of the world's population, now accounts for roughly 40% of world trade, 35% of global GDP and 30% of global personal consumption.[1] It is a region of great wealth ($40,200 per capita income in Japan), great poverty ($2,100 per capita income in India), and continued rivalries. Yet some countries across this vast space have forged pathbreaking economic ties, first in 2018 via the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), a free trade agreement between seven Asian countries and Canada, Mexico, Chile and Peru; and in December 2020 via the Regional Comprehensive Economic Partnership (RCEP), now the world's largest trading bloc, encompassing ten countries of Southeast Asia, plus South Korea, Japan, Australia, New Zealand, and China.

Perhaps the most profound change is China's transformation from bit player to global heavyweight. China has become a manufacturing juggernaut, a superpower in global trade, a significant exporter of capital, and a world leader in a number of cutting-edge industries, from quantum computing to life sciences. Its $15 trillion economy is second in size only to that of the United States.

On a per-capita basis, of course, China still has far to go. Per-capita GDP in China ($10,262 in 2019) significantly lags that of the United States ($65,298) and EU member states ($34,919 on average). Household consumption as a share of GDP is still by far the lowest of any major economy.

Nonetheless, China's impressive economic strides, together with the sheer scale of its immense population and the huge sweep of its resource and related needs, have made China a global heavyweight. Like other rising great powers in history, China wants to match its economic stature with more global influence – in the Asia-Pacific, the Middle East, Africa, Latin America, Eurasia and Europe. It seeks a larger voice in multilateral institutions like the United Nations, the International Monetary Fund, and the World Health Organization. It is constructing alternative regional organizations such as the Asian Infrastructure Investment Bank and has advanced a new type of "connectivity politics" via its Belt and Road Initiative. It is challenging basic norms of the rules-based international order and attempting to define new technical standards in a host of international bodies. It has ignored international legal rulings that have questioned its assertions of territorial and maritime sovereignty. All of this has raised fears of the so-called "Thucydides trap" – a scenario where a rising star (China) and an established power (the United States) end up, like Athens and Sparta, at war.

Politics and Profits

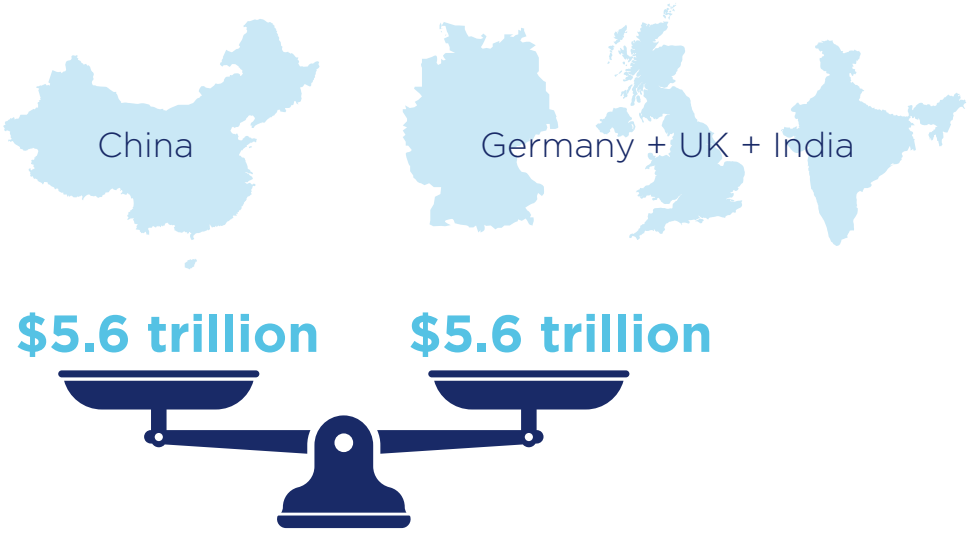
For most of this century, China's relations with the United States, Europe, and Asian democracies ebbed and flowed between cooperation and competition. Tensions would flare up, but never burned too hot or too long. That has changed in recent years, spiked in particular by antagonism between Washington and Beijing. While the COVID-19 pandemic pushed U.S.-China relations over the edge, the split between the two parties was years in the making. Even before the election of Donald Trump – the most aggressive, get-tough-with-China president in modern times – bilateral relations were adrift and fraying at the seams. Tensions have long been stoked by the hollowing out of the U.S. manufacturing base, with U.S. politicians on both sides of the aisle faulting China's unfair trade practices for the decimation of U.S. jobs and incomes. America's ever-expanding trade deficit with China has been a perennial sore spot for various U.S. administrations for years. Also undermining relations: Beijing's state-sponsored policies like "indigenous innovation," "Made in China 2025," "civil-military fusion," its treatment of Uighur and other minorities, efforts to export its brand of digital illiberalism, its anti-democratic crackdown in Hong Kong, and efforts to bully non-compliant actors.

European countries share many of these U.S. concerns. They too are frustrated by Beijing's cybertheft and disruption activities, its assaults on intellectual property, its efforts to pressure companies into technology transfer arrangements, market-distorting subsidies, shutting out non-Chinese digital companies from the Chinese market, restrictions on foreign investments in services, agriculture and other high-tech sectors, poor implementation of its WTO obligations, and its overcapacity in steel and potentially autos, robotics and other sectors of the economy. They too are wary of investments by state-owned Chinese firms in strategic infrastructure and technologies in Europe, the United States, and other countries. Europe also shares U.S. concerns about China's human rights abuses.

Nonetheless, for most of the past decade, many European countries have preferred to look at China primarily through the prism of economic opportunity – a lucrative market for German carmakers and French and Italian luxury goods companies, and a potential source of capital for hard-pressed countries in central and eastern Europe.

Despite China's transgressions on trade agreements and investment protocols, many countries and companies preferred profits to politics. As a result, China has emerged as one of the largest and most dynamic consumer markets in the world, underpinning global automakers, food and beverage firms, technology and financial leaders, aerospace firms, airlines, and many other enterprises. General Motors now sells more vehicles in China than in the United States; the same holds true for Germany's premier automakers like BMW and Mercedes Benz. Pick virtually any sector – luxury goods, fitness apparel, fast food – and there is a good chance that China rivals the United States as the top market in the world, due to its burgeoning middle class consumer base. China accounted for a staggering 27% ($5.59 trillion) of total consumer spending of developing nations in 2019. That is almost equivalent to the combined annual consumer spending of Germany, the UK and India ($5.58 trillion).

Consumer spending (2019)



Trade in goods and services (2020)

Commerce Is More Than Trade, and Trade is More Than Flows of Goods

China's rise has translated into burgeoning trade in goods, including with Europe. According to figures from the IMF, EU28 goods exports to China expanded at a compounded annual rate of 13.2% between 2000 and 2019, compared to 4.5% annual growth in exports to the United States. EU28 goods imports from China, meanwhile, rose 10.7% over the same time period, while U.S. goods imports expanded by just 2.7%.

These numbers have reinforced a fairly widespread – yet incorrect – view that China has become Europe's top commercial partner, reinforced by a February 2021 report by Eurostat, the EU's statistical agency, that EU27 goods trade with China in 2020 totaled €586 billion, compared to €555 billion in EU27 trade with the United States. That is a significant change from 2019, when EU27 trade with the United States was €617 billion, whereas EU27 goods trade with China was €561 billion.[2]

Trade between countries, however, doesn't just consist of trade in goods. It also includes trade in services, which the Eurostat report did not include. Services trade has been growing faster than goods trade. More European and American jobs depend on services than on goods, and the United States remains the EU's top services trade partner.

While final numbers for trade in services are not yet available for the full year 2020, we do have data for the first three quarters of the year. Trade in services between the EU and the United States during that period was €296.3 billion – five times more than the trade in services between the EU and China, which totaled €53.3 billion.[3]

If we annualize those figures to estimate the EU's total trade in goods and services for 2020, we find that EU27-China trade in goods and services likely totaled €657 billion in 2020, while EU27-U.S. trade was €950 billion – 40% higher.[4]

In short, if you look at overall trade flows and not just one kind of flow, it is clear that the EU's largest trading partner is actually the United States, as it has been for decades.

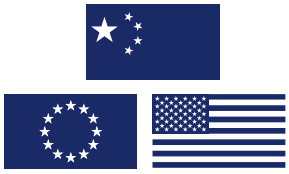
The Two-Lane Highway vs. the Twelve-Lane *Autobahn*

Just as trade is more than just flows of goods, international commerce is more than just trade. Reducing complex commercial ties to one metric – trade in goods – ignores the importance not only of services, but a host of additional economic ties that bind the EU and the United States in far deeper ways than those that bind either to China.[5]

U.S. and European commercial ties with China are akin to a two-lane highway, whereas their commercial ties with each other are more like a twelve-lane *Autobahn*.

The highways to and from China are full of goods. They are busy, and they are crowded. Any type of accident on a two-lane highway can really snarl traffic – as we saw when supply chains were disrupted by the pandemic and by the U.S.-China tariff war.

Alongside the highway are narrow bike lanes for services. The EU and China have been busy trying to build a new lane on their highway – an investment path that they believe could unsnarl some of that traffic and add to their overall connections. Despite the EU-China Comprehensive Agreement on Investment inked in December 2020, however, that investment lane remains a construction site, as opposition has arisen in some member states and in the European Parliament, which ultimately have to sign off on a final deal. Road construction on that deal is likely to continue through 2021.



The ties that bind the EU to the United States are much thicker and far deeper than those that bind either to China

The commercial highway connecting the EU with the United States, in contrast, looks more like a twelve-lane *Autobahn*. Not only are there fewer speed limits and an even wider lane for goods, there are additional lanes for services, investment streams, and sales of companies on each side of the Atlantic. The transatlantic digital lanes carry 75% of global digital content. The innovation lanes hosting research and development flows are the most intense between any two international partners. The jobs lanes provide employment for 16 million Europeans and Americans.

We show throughout this report that on each of these metrics, the ties that bind the EU to the United States are much thicker and far deeper than those that bind either to China.

Share of the EU's total outward FDI position globally

(2018)

U.S.
32%

China
2.5%

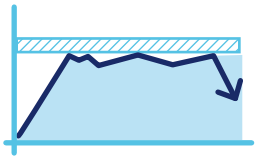
The U.S. accounted for 32% of the EU's total outward FDI position globally in 2018, whereas China accounted for just 2.5% of the total. Total European stock in the United States of $2.9 trillion in 2019 was more than three times the level of comparable investment from Asia. Germany's total FDI stock in the United States totaled $373 billion in 2019. Chinese FDI stock in the United States was only one-tenth of that total ($37 billion).

Europe's role vis-à-vis the United States is very similar. Measured on an historic cost basis, the total stock of U.S. FDI in Europe was $3.6 trillion in 2019 – 60% of America's total global investment position and almost four times U.S. investment in the Asia-Pacific region. U.S. FDI in the UK in 2019 was seven times more than such investment in China. Equivalent U.S. investment in Germany was 1.3 times more than in China.

When flows from holding companies are removed, Europe still accounted for over half of total U.S. FDI outflows globally and more than double the share to Asia over the past decade through 2019.

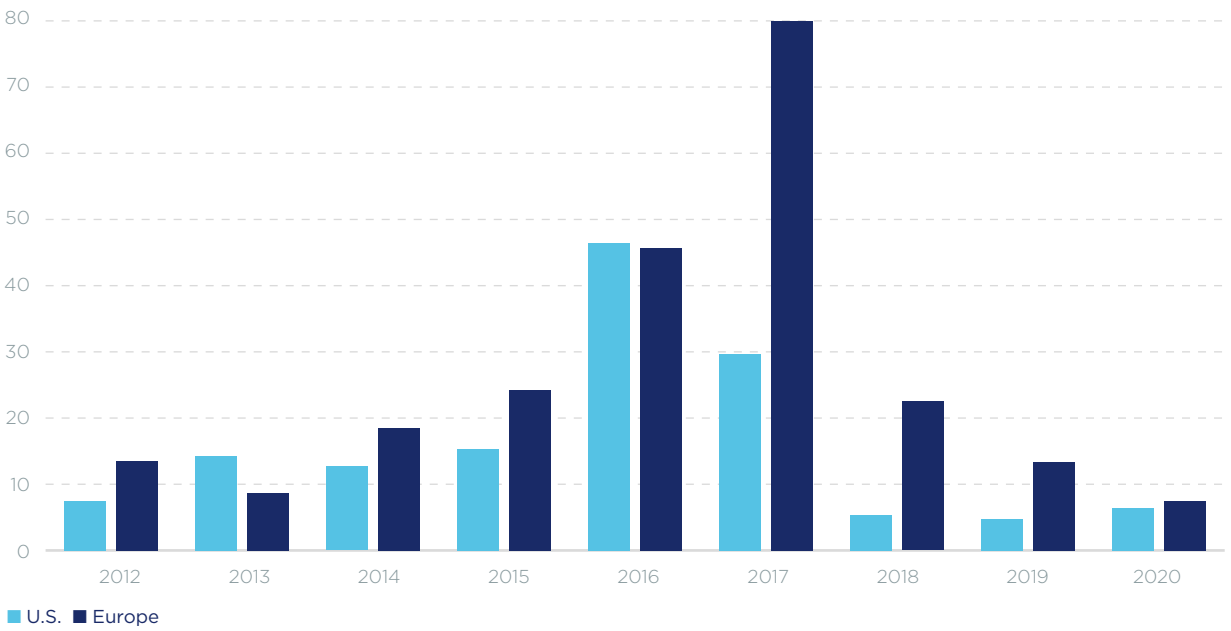
In the first three quarters of 2020, U.S. companies invested $55 billion in Europe, seven times more than what Chinese firms invested in Europe. And despite the pandemic-induced recession, U.S. companies in 2020 earned an estimated $254 billion from their operations in Europe – 23 times what they earned from operations in China.

Deep and thickening transatlantic investment ties contrast starkly with FDI coming to each continent from China. For some years Chinese FDI in both the United States and Europe soared from a relatively low base. However, Chinese investment is now plummeting on both continents due to bilateral commercial tensions and tighter U.S. and European scrutiny of such investments (Table 1). Chinese investment flows to the United States rose slightly to approximately $6.4 billion last year, although Chinese FDI in Europe fell by 44% to $7.5 billion. Relatively low Chinese FDI, in turn, generates relatively few U.S. and European jobs. Mutual flows of investment across the Atlantic, in contrast, provide directly for close to 10 million jobs.



Chinese investment is now plummeting in both the EU and the U.S. due to bilateral commercial tensions and tighter investment screening

Table 1. Value of Completed Chinese FDI Transactions in Europe vs. U.S. ($ Billions)



Data represents greenfield investments and acquisitions that result in significant ownership control (>10% of equity) in the U.S. and Europe, excludes divestitures. Europe includes EU28 plus Norway, Switzerland, Iceland, Liechtenstein.
Source: Rhodium Group; Baker McKenzie.
Data as of January 2021.

The digital revolution has further enhanced the importance of the transatlantic economy in comparison with U.S. and European ties to China. U.S. exports of digitally-enabled services to Europe in 2019 were double equivalent exports to the entire Asia-Pacific region, and EU exports of digitally-enabled services to the United States alone were greater than equivalent exports to Asia and Oceania.

Despite the tremendous political and economic headwinds that have buffeted the transatlantic relationship in recent years, the United States and the EU remain each other's most important trading partners and each other's most significant commercial markets – bar none.

At the end of the day, U.S. and European multinationals make their living on the other side of the Atlantic, rather than across the Pacific. As one CEO said to us, "we are positioning ourselves for China. But at the moment, we are earning our money in Europe." U.S. affiliate income in Europe during the first nine months of 2020 of $180 billion was 25 times more than U.S. affiliate income in China ($7.1 billion) and roughly 55% of all U.S. global foreign affiliate income. We estimate that income of European affiliates in the United States in 2020 fell 32% to $91 billion, but that was after hitting a near-record level of $134 billion in 2019 – far more than European affiliate income in China and in Asia overall.

Foreign affiliate income (Q1-Q3 2020)

$180 billion
U.S. affiliate income in Europe

25X

$7.1 billion
U.S. affiliate income in China

All of these facts run counter to the fashionable narrative that U.S. and European companies prefer China or other lower-cost nations to developed markets. The reality is different, for several reasons. First, investing in Europe or the United States is relatively easy, while investing in China remains difficult because of onerous restrictions on foreign ownership and forced technology transfer rules, not to mention heavily subsidized competition from state-owned and state-controlled Chinese companies. Moreover, investors can trust the legal systems and transparent regulatory models in the United States and across Europe. Not so in China.

Second, growth prospects in China have slowed not only because of the coronavirus but because Beijing has shifted toward more consumption- and services-led growth and away from export- and investment-driven growth.

Third, in addition to being two huge markets, the United States and Europe are wealthy, which is correlated with highly skilled labor, rising per capita incomes, innovation, and world class R&D infrastructure, among other things. Together the United States and Europe account for half of global consumption, and gaining access to wealthy consumers is among the primary reasons why U.S. and European firms invest in each other's markets.

Rethinking Global Supply Chains

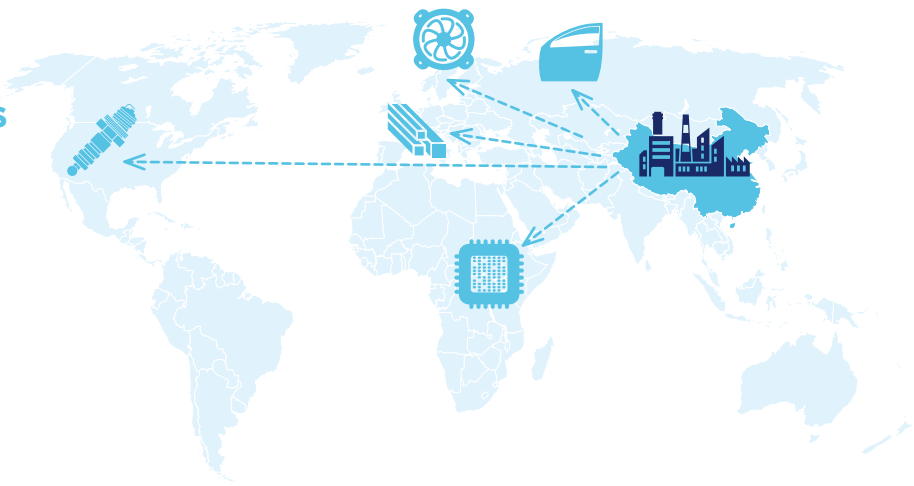
Most Western companies are in China because they seek to expand their presence in the Chinese domestic market, not because China is a cog in their extended global supply chains. Nonetheless, about 20% of global trade in manufacturing intermediate products used in supply chains now originates in China, up from 4% in 2002. Chinese manufacturing is essential to many global supply chains, especially those related to precision instruments, machinery, automotive and communication equipment, but also other key industries such as pharmaceuticals.[6]

China's key role was painfully driven home when Beijing locked down its economy in late January 2020. As factories were shuttered across the country, the ripple effects were felt far and wide. Governments and major companies were confronted with the prospect that many global supply chains had become too complex, too far from home, and above all else, too China-centric.

China's Hubei province, the original epicenter of the pandemic, is an auto manufacturing hub. When it shut down, auto supply shortages quickly appeared across Asia, Europe and the United States. Shortages of key electronic parts and components swiftly emerged, penalizing some of the largest technology companies in the world. Apple, reflecting its dependence on China as a key supplier and assembler of iPhones, cut its sales expectations following China's lockdown. Textile and apparel designers were denied their seasonal supply of products as Chinese factories went quiet. Most distressing was that Chinese-produced medical supplies, ranging from masks and ventilators to critical pharmaceutical ingredients, dried up in the world's greatest hour of need.[7]

In the pre-COVID-19 world, little concern or attention was paid to the fact that China was producing half of the world's medical masks, that nearly three-quarters of blood thinners imported by Italy were sourced from China, that Japan relied on China for 60% of its total imports of antibodies, or that China accounted for 40% of Germany's, Italy's and France's imports of antibodies. According to the U.S. Commerce Department, 95% of ibuprofen, 91% of hydrocortisone, 70% of acetaminophen, 45% of penicillin, and 40% of heparin imported into the United States in 2018 came from China.[8]

20% of global trade in manufacturing intermediate products used in supply chains originates in China, up from 4% in 2002.



Why companies are reorganizing their global supply chains

Negative impact of too much concentration and complexity highlighted by COVID-19

Data security and privacy concerns

Changing cost considerations (labor and production)

Environment, social and governance factors prioritized by investors

Technological progress and digital innovations

These dependencies in specific areas do not mean, however, that China has suddenly come to dominate critical supply chains. According to the WTO, Germany is the largest exporter of medical goods worldwide ($136 billion in 2017, latest available) followed by the United States as the second largest exporter of medical goods worldwide, with exports of $116 billion. The United States is the world's second largest exporter of ventilators, trailing only Singapore, and the third largest exporter of personal protective equipment.

The top sources of U.S. imports of medical products are Ireland ($26 billion), Germany ($16 billion), and Switzerland ($13 billion). China comes in fourth place at $12.5 billion, or half Ireland's figure.

Census data on U.S. imports (2019) confirm that China's role in pharmaceutical manufacturing has been exaggerated. China isn't even among the top 15 sources of U.S. imports of vaccines or finished pharmaceutical products (FPPs), and it accounts for 9% of U.S. imports of antibiotics (active pharmaceutical ingredients (APIs) and FPPs). China was the source for 15% of U.S. imports of APIs and just 4% of U.S. imports of all pharmaceutical products last year.

In addition to robust domestic manufacturing in the pharmaceutical sector, the United States draws on a diverse array of suppliers to mitigate possible supply chain risks. According to U.S. Census data, Ireland (21%), Germany (13%), and Switzerland (12%) are the top sources of U.S. pharmaceutical imports. Ten additional countries (eight in Europe plus India and Japan) account for between 3% and 6% each.

Nonetheless, the pandemic and its ripple effects generated disruptions across both China-centric and transatlantic supply chains. In the end, 950 of *Fortune*'s top 1000 companies reported supply chain disruptions in 2020. Firms across the world were forced to re-evaluate how and where to organize their global operations. Not only did they realize that some of their supply chains had become too concentrated, the pandemic laid bare the uncomfortable fact that these interconnected webs had also become so complicated and opaque that even the companies involved did not fully understand where intermediate components and critical materials essential to their products came from.[9]

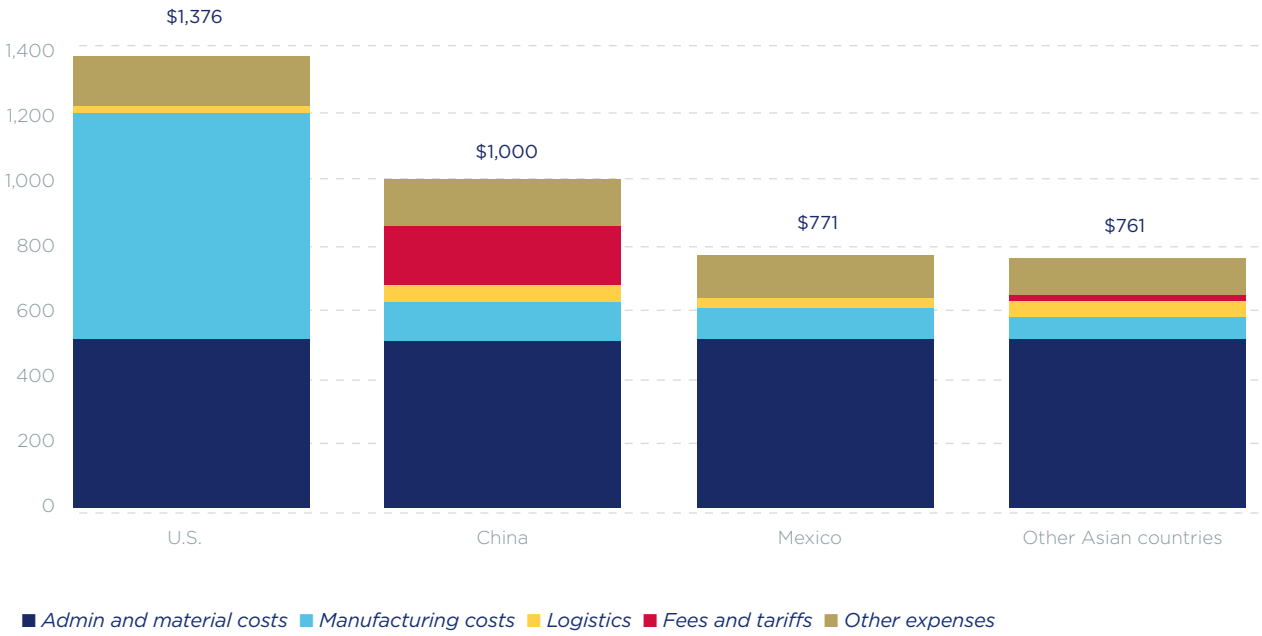
Even before the pandemic hit, countries and companies were reconsidering the pros and cons of allowing China to become "the factory of the world." Fears have grown that making equipment in China might put data security and privacy at risk. National security, already a concern, has become a priority. Japan set aside $2.2 billion to help and encourage Japanese firms to relocate from China. The UK government launched "Project Defend" to examine how to reduce reliance on China. Similar motivations shaped the EU's package of post-pandemic recovery spending. Just weeks after taking office, the Biden administration launched a 100-day review of ways to mitigate U.S. dependencies on supply chains involving semiconductors, electric vehicle batteries, rare earth metals and medical products, to be followed by a deeper one-year review of a broader sectors such as defense, public health, biological preparedness, information and communications technology, transportation, energy and food production.

Changing cost considerations have also caused rethinking. One reason why China became such a critical cog in global supply chains was its competitive cost of labor and production. That advantage is disappearing, to the benefit of Mexico and southeast Asian countries (Table 2). In 1990, China had an average monthly wage of $55. By 2018, that increased to $990 – three times higher than in Vietnam and nearly double that in Mexico. The result: footwear, accessories, toy and furniture manufacturers began moving out of China more than a decade ago. More than 83% of North American businesses and about 90% of European firms have announced plans to relocate at least part of their supply chains away from China.[10]

Environmental, social, and governance (ESG) considerations are also causing a rethink of China-centered supply chains. Investors are starting to signal that they are likely to give greater weight to the ESG scores of large companies.

Table 2. China's Disappearing Cost Advantage

Cost of making a hypothetical product, selected countries ($)



The hypothetical product is produced in China at a total cost of $1,000. The manufacturing cost is 10% of the cost of goods sold and the logistics cost is 5%.
Source: PwC; The Financial Times.

Finally, as we note in Chapter Three, technological progress and digital innovations are challenging old assumptions that supply-chain resiliency can be achieved only at the cost of efficiency. [11]

All of these considerations were already underway before 2020. The pandemic rendered each of them more acute. Companies and countries around the world are looking to redefine the terms of their interdependence. In some cases, this is leading to new strategies of diversification. Others are taking a more extreme step, which they call decoupling.[12]

The new landscape is likely to be very different than before the pandemic, as the one-world, hyper-globalization model of just-in-time supply chains built around hyper-efficient cross-border trade in tasks, which enabled China to become the world's factory, is reshuffled into a different type of globalization – that is, a globalization built around less complex and opaque, and more resilient and robust supply chains framed by China/Southeast Asia on the one hand, and the United States and Europe on the other. These changes are evident across a number of critical industries, from foodstuffs, pharmaceuticals and semiconductors to medical equipment, critical materials and defense-related supply chains. All told, McKinsey estimates that as much as $4.6 trillion in trade flows may be rebalanced across geographies in coming years.[13]

1 Asia here is defined as the entire Asia-Pacific region, including South Asia and developed Asia and Oceania countries including Japan, Australia and New Zealand.
2 Eurostat, "Euro area international trade in goods surplus €29.2 bn," February 15, 2021, https://ec.europa.eu/eurostat/documents/portlet_file_entry/2995521/6-15022021-BP-EN.pdf/e8b971dd-7b51-752b-2253-7fdb1786f4d9.
3 Eurostat, balance of payments database, https://ec.europa.eu/eurostat/web/balance-of-payments/data/database.
4 U.S. goods trade with the EU28 in 2020 ($757 billion) was also much larger than U.S. goods trade with China ($560 billion).
5 Unfortunately, a number of public agencies in Europe make the mistake of reducing overall trade to just trade in goods. The German Federal Statistical Office, for instance, consistently proclaims that China is Germany's top trading partner, even though those claims are patently false if one looks at overall German-China trade, not just trade in goods.
6 UNCTAD, "Global trade impact of the coronavirus (COVID-19) epidemic," March 4, 2020, https://unctad.org/en/PublicationsLibrary/ditcinf2020d1.pdf.
7 See Jon Emont and Chuin-Wei Yap, "Companies That Got Out of China Before Coronavirus Are Still Tangled in Its Supply Chains," *Wall Street Journal*, March 8, 2020.
8 Keith Bradsher and Liz Alderman, "The World Needs Masks. China Makes Them, but Has Been Hoarding Them," *New York Times*, April 2, 2020; Daniel F. Runde and Sundar R. Ramanujam, "Global Economy – Recovery with Resilience: Diversifying Supply Chains to Reduce Risk in the Global Economy," CSIS, https://www.csis.org/analysis/recovery-resilience-diversifying-supply-chains-reduce-risk-global-economy.
9 Nathaniel Taplin and Charley, "If Coronavirus-Stricken China Can't Export Medicine, the World Is in Trouble," *Wall Street Journal*, March 4, 2020; Martijn Rasser, "Pandemic Problem: America's Supply Chains are Dangerously Brittle," *National Interest*, March 17, 2020, https://nationalinterest.org/feature/pandemic-problem-americas-supply-chains-are-dangerously-brittle-134022.
10 Kathrin Hille, "The great uncoupling: one supply chain for China, one for everywhere else," *Financial Times*, October 6, 2020; Kathrin Hille, "China's share of global exports falls in supply chains rethink," *Financial Times*, August 17, 2020; Runde and Ramanujam, op. cit.
11 See also McKinsey, "Risk, resilience, and rebalancing in global value chains," August 6, 2020, https://www.mckinsey.com/business-functions/operations/our-insights/risk-resilience-and-rebalancing-in-global-value-chains.
12 Torsten Riecke, "Resilience and decoupling in the era of great power competition," MERICS, August 20, 2020, https://merics.org/en/report/resilience-and-decoupling-era-great-power-competition.
13 McKinsey, "Reimagining industrial supply chains," August 11, 2020, https://www.mckinsey.com/industries/advanced-electronics/our-insights/reimagining-industrial-supply-chains; Hille, "The great uncoupling," op. cit.