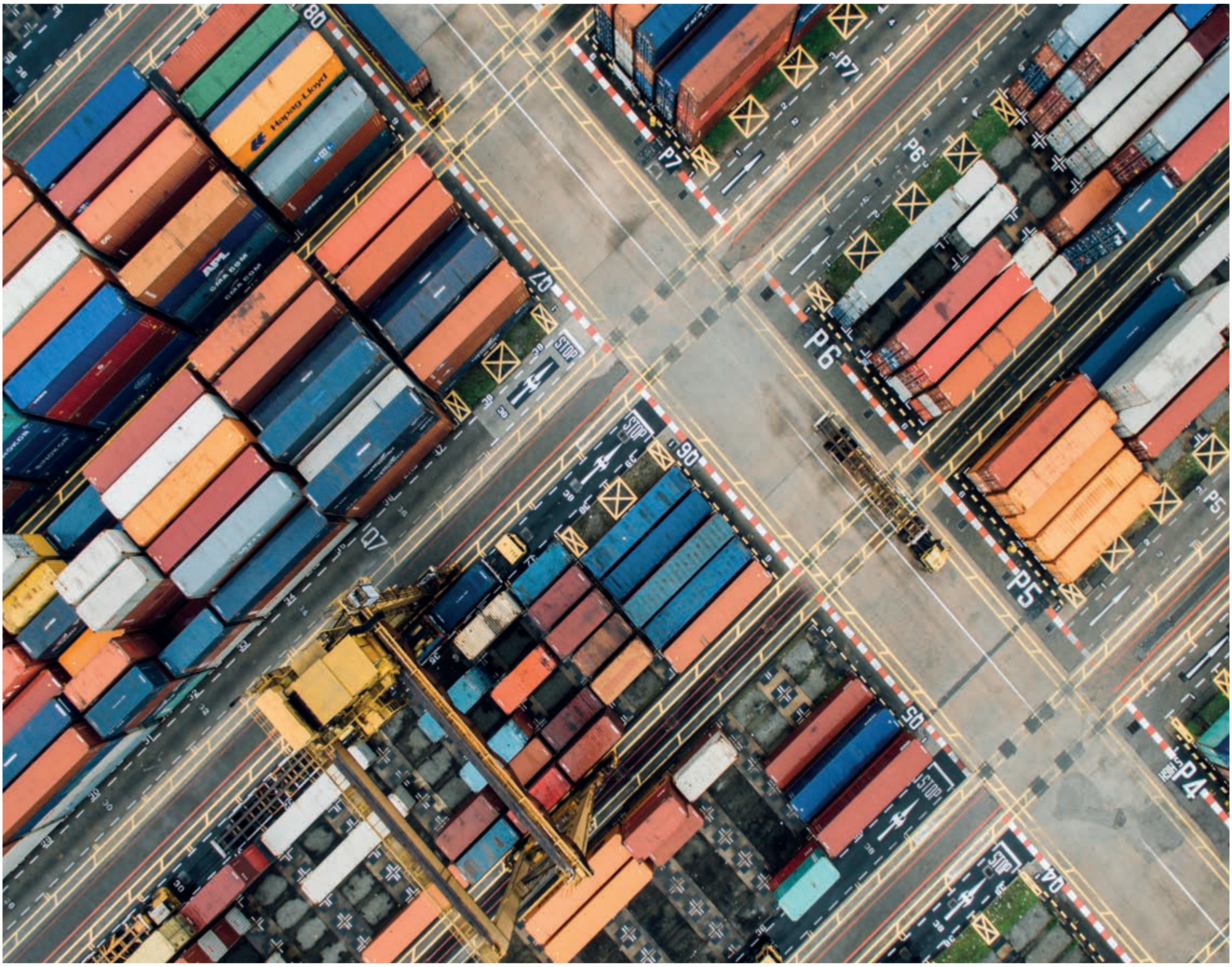


Theme: Global fragmentation

A critical inflection point with major consequences

Warning bells are ringing as the world faces a critical inflection point. Economists and various international organisations, such as the International Monetary Fund (IMF) and the World Bank, now see a disturbing pattern in which the world is taking clear steps towards geoeconomic, geofinancial and geotechnological fragmentation. This means the world is being divided into a number of large rival blocs, with countries in each bloc – in practice – only wanting economic, financial and technological relations with each other.

Countries today are using economic policy to a growing extent to build up their "national defence" – partly through increased self-sufficiency (so-called strategic autonomy) and partly through reduced dependence on rivals – as well as to prevent the rise of new economic and military superpowers.

The question being asked in corporate boardrooms and economic policy circles is: how great is the risk of permanent fragmentation, in other words, of the world being divided up into different economic, financial and technological trade blocs? There is enormous and growing interest in this question, which was confirmed when it was made the theme of this year's World Economic Forum meeting in Davos, Switzerland, held January 16-20 – Cooperation in a Fragmented World – and because the number of times this issue has been mentioned in corporate earnings reports has increased tenfold in just two years, according to the International Monetary Fund (IMF).

The role of systemic crises in fragmentation

The world is now in an extremely complicated and uncertain situation, which is affected by a number of severe crises. The COVID-19 pandemic, the war in Ukraine and climate change are three partly intertwined systemic crises that have become catalysts for major changes in the world and have initiated processes among various decision makers within a historically short period of time – processes aimed at assessing and rethinking economic, financial and security policy relations as well as desired and undesired dependency relationships.

These systemic crises are accompanied by other ongoing structural trends, which include clear demographic headwinds such as ageing populations, pandemic-related imbalances and rapid advances in the Fourth Industrial Revolution. Meanwhile, the climate and energy crises and the war in Ukraine have increased the need for an accelerating energy transition.

Some of the fragmentation now under way has an economic and financial logic and should therefore be embraced. These systemic crises have exposed unwanted weaknesses and vulnerabilities in companies' global value chains, which need to be addressed. However, tensions around global trade, technology and security have increased in recent years, with a spotlight placed on trade and technology disputes between the United States, the European Union and China, among other matters. So there are reasons to build a more secure, more stable and greener economic and financial system – but in a way that meanwhile does not jeopardise the gains achieved from an integrated, globalised world.

Tectonic shifts in the global playing field affect the global economy

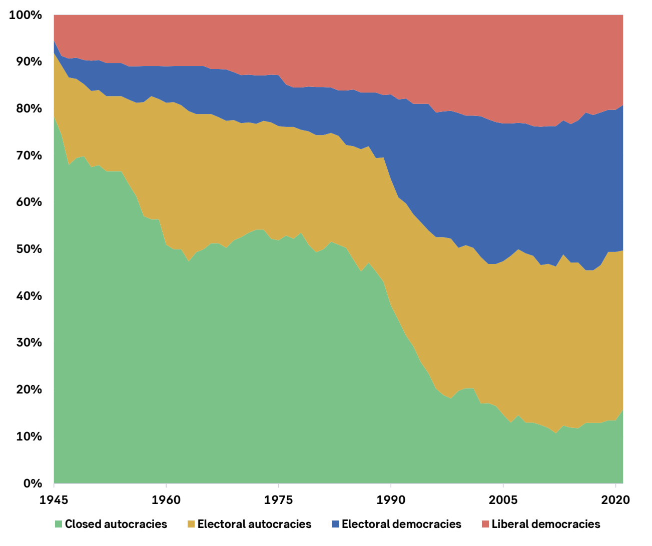
Geopolitical changes interact with economic challenges and technological shifts in a very powerful way. Increased fragmentation entails numerous long-term risks and potential costs – lower profitability and poorer resource use, deferred and generally lower investments, decreased innovative capacity and dissemination of knowledge, reduced productivity and lower employment. It is unfortunately difficult for economic models to quantify the effects of this at present.

The IMF's cost calculations for geoeconomic fragmentation vary significantly, depending on different assumptions about future developments. The IMF warns that the cost may be as much as 7 per cent of global GDP, equivalent to 7 trillion US dollars. However, some calculations indicate that the cost of fragmentation would be much higher.

Geoeconomic fragmentation also reinforces oligopolistic domestic structures as global competition and technology transfers are restricted and regionalisation gains ground. This fragmentation can inhibit production, investments and innovation, which are needed, for example, to replace carbon-intensive processes with climate-friendly ones. The goal of a carbon-neutral planet will be harder to achieve without rapid, globally available technological solutions. These, in turn, depend on the exchange of knowledge, raw materials and people needed for the speedy electrification of our economies.

All in all, this may lead – in a longer perspective – to higher costs for companies and higher inflation and thus higher interest rates, including for households. In the short term, global inflation is expected to fall as pandemic-related supply and demand imbalances narrow and supply disruptions ease. But the structural effects of fragmentation on inflation and interest rates may cause persistently higher global inflation and higher interest rates due to a higher inflation risk premium, as well as higher demand for capital in a financial market that also risks becoming fragmented.

The future of democracy



Source: ourworldindata.org/democracy

Companies must take into account increased geopolitical and domestic political risks in their business models. There are signs of an increase in the number of autocracies (authoritarian regimes without general elections), and the new security policy situation may reinforce this trend.

Geofinancial fragmentation

The rapid, powerful economic globalisation of recent decades has also led to a parallel globalisation and integration of national financial and credit markets. Increased global trade in goods, growing interest in direct investments and ever larger global savings imbalances have bolstered the need for cross-border capital flows, risk reduction opportunities and supranational institutions that work to ensure a smoothly functioning international monetary system, controlled in part by such organisations as the IMF and the Bank for International Settlements (BIS) in Basel. However, there has been growing criticism from emerging markets that they are underrepresented in the international monetary system.

The financial isolation of Russia by other countries, including a freeze on the Russian central bank's currency reserves, has created legitimate concerns – for example among central banks in emerging markets and commodity-producing countries as well as these countries' state-controlled pension funds. The world's biggest currency reserves and funds are in countries whose political and value-based systems are being viewed in another light amid today's new security policy landscape. Some 55-60 per cent of global currency reserves, worth about 13 trillion dollars, are invested in dollars and about 20 per cent are invested in euros; only 2.5 per cent have been invested in Chinese yuan.

"Security policy vulnerabilities must be exposed, and financial and technological dependency relationships must be identified."

Both trade and capital flows may change direction due to the risk of assets being frozen or of requirements from customers or authorities that no money may be invested in – or no trading may be conducted with – countries that do not share the same human rights values, rule of law principles or other principles of the international community, or that do too little to tackle the climate crisis. This implies changes in the structure and stability of the international monetary system.

A greater concentration of financial risks, when the opportunity to spread risks is reduced as fragmentation grows, may also increase macroeconomic volatility and the risk of economic and financial crises. Reduced international cooperation on financial stability will also contribute to higher risk premiums and depressed asset prices.

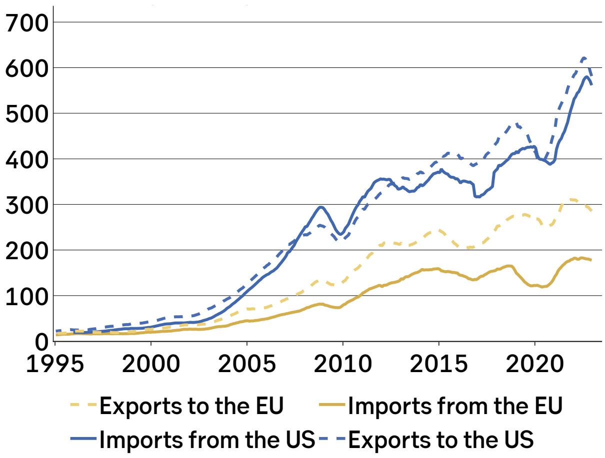
Globalisation versus deglobalisation

Achieving stable, predictable and sustainable earnings now needs to be included as an important parameter in economic decision-making. The question is whether this can be achieved without jeopardising the continued positive results that a globalised, integrated world produces. Increased geoeconomic fragmentation has the potential to add to the supply shocks generated by the pandemic and the war in Ukraine.

Security policy vulnerabilities must be exposed, and financial and technological dependency relationships must be identified. When geostrategic and geopolitical aspects become part of economic policy decision-making, there is a significantly higher risk of less efficient production, worse resource allocation and rising costs.

China's explicitly stated goal – which is shared by such countries as India and Russia – is to reduce the role and influence of the West and especially the United States on the global economic, financial and security policy agenda. At the turn of the year China's president, Xi Jinping, reiterated that Beijing and Moscow should deepen their coordination and collaboration in international affairs. He also noted the ideological affinity between China and Russia as well as their dissatisfaction with US leadership of the West. The growth of populism in the US and Europe has also contributed to this development.

China's trade with the US and the EU



Source: China General Administration of Customs (GAC), Macrobond, SEB

China plays a significant role in global trade, especially for the United States. Further steps towards fragmentation, and reduced trade, may have major consequences for economic growth and costs.

Six centrifugal forces

One can draw a picture of this new world, with different geographic trading blocs built up around six "centrifugal forces". The first force involves shared values and ideologies – that is, future trade will be determined to a greater extent by countries – political leaders and companies – sharing values and political ideologies. The second force is focused on political systems. Pessimists maintain that the "the future of democracies" in general will be increasingly questioned on account of various domestic political events, for example, in the US and the EU during 2021 and 2022.

The US dollar's historical dominance of financial markets and its prominent role as a so-called reserve currency are disliked by various emerging markets, led by China, India and Russia. As the global economy evolves, it is also reasonable to have a more multipolar currency system. The third centrifugal force is thus focused on reserve currencies and the ambition to make the world more dependent on the Chinese yuan. The fact that US and EU sanctions against Russia during 2022 have also involved excluding Russian banks from the SWIFT international payment system has raised the question of whether future trade flows using China's payment system may be the fourth centrifugal force.

The last two forces that may contribute to increased fragmentation and the division of the world into trade blocs – technology standards and trade policy – will also create growing challenges for international companies, which will be forced to manage different systems dependencies, based on their geographic presence.

Global systemic crises over the past three years and other structural forces have created tectonic shifts in the global playing field. This is something that companies, households, political leaders and central banks need to respond and adapt to. Such changes will have consequences – among other things for economic growth, the profitability of companies, global debt and the international monetary system.

What continues to be an extremely serious security policy situation will most likely play a major role in what the future will look like. A carbon-neutral world will not be possible without rapid technological solutions. These, in turn, will depend on access to knowledge, materials and people. Fragmentation is thus a serious threat not only to economic prospects but also to our ability to tackle the crisis of climate change and biological diversity.

US climate plan splits the world

The world is divided over the US Inflation Reduction Act (IRA) – which includes a historic, far-reaching USD 369 billion climate package; see the theme article "US climate policy: Finding balance between competition and EU-US cooperation" in the January 2023 issue of *Nordic Outlook*. Researchers give President Joe Biden's green policy the thumbs up. It is also a policy focused on "carrots" rather than "sticks" to enable the US to achieve its climate goals.

The US is now showing welcome, concrete leadership on the climate issue. The apparent goal of the IRA is to make American green energy and technology an important future export product, reduce US dependence on other countries (increase strategic autonomy) and generate more green jobs at home.

But the package is also part of an industrial and trade policy that gives domestic manufacturers competitive advantages in ways that violate World Trade Organisation (WTO) rules. After extensive criticism from the European Union, the Biden administration has made minor concessions, but the package remains in force. The political balance in the US Congress makes major changes in the package difficult.

The EU has launched its own green policy, but it is not enough. A global race to develop green technology is welcome in the ongoing climate crisis. But if the world is now moving towards greater geoeconomic fragmentation, this decreases the chances that green technology transfer can help solve the climate crisis. Our conclusion is that the EU must build on its own industrial and climate policy.

The need for continued good transatlantic relations in an increasingly strained geopolitical situation means that it is now up to the EU to increase its attractiveness and competitiveness. But achieving maximum global exchanges of green technology and transition strategies will require coordination of climate, industrial and trade policies. Political leaders will also need to ensure that large industrial subsidies and domestic production requirements lead to the right mix and balance between competition and collaboration, without further fuelling protectionism.

Global fragmentation: Winners and losers

The reassessment of economic, financial and security policy relationships described in the previous theme article will affect nearly every sector and create both risks and opportunities for many Swedish companies. Overall, there is a clear risk that this will have negative effects on most global companies. But some will be affected more than others, and not just negatively. We have listed a number of companies that will benefit from this transition, but also companies that will have a much tougher time in a new geoclimate.

One consequence of global fragmentation is the establishment of more local value chains among companies in an effort to reduce their vulnerability. Other consequences are a greater need for self-sufficiency in energy and key input goods, such as critical metals and semiconductor technology. Another repercussion is that, given more regional variation in technology standardisation and regulations, there may be a risk of a decline in technology transfers and an increase in development costs. The majority of large Swedish international companies have tackled the problems that have arisen over the past three years in an impressive way. Despite component shortages, sharply higher costs, absences due to illness, flexible workplaces, lockdown effects in China, the divestment of often lucrative operations in Russia and related impairment losses, profitability has remained high. While Swedish companies have weathered the situation well, there continues to be a need for rapid adjustments and flexibility.

The mining sector will benefit from the ambition to increase Europe's metals self-sufficiency

Metal prices have trended upward in recent years, given the combination of falling metal content in the ore extracted at many existing mines and mining companies' focus on cash flow, with limited investments in new capacity. A clear electrification trend in passenger cars is boosting demand for metals such as copper and nickel. Few permits have been issued for new mines in Sweden, and there are long lead-times between the submission and approval of such an application. If political leaders and decision makers consider it strategically important to increase the critical metals supply in Europe, this may lead to proposals to make permitting processes easier. Such changes should benefit Boliden and increase the likelihood of profitable new mines like the company's copper mine in Laver, Sweden. Suppliers of mining equipment, such as Sandvik and Epiroc, will also benefit if mining companies increase their investments in new mine projects.

Increased sales potential for defence companies, but also changes in risk

Most European countries have reassessed their military defence investment levels after Russia's invasion of Ukraine. So far, most increases in investments have consisted of aid to Ukraine in the form of weapons, ammunition and military training. NATO's previous target was for its member countries to invest 2 per cent of their gross domestic product in defence. Countries bordering Russia invest even more than this. In Sweden too, there is also a discussion about whether 2 per cent should be considered a floor rather than a ceiling. This is a significant change. Listed companies such as Saab, Kongsberg and Mildef would be favourably affected by increased defence spending, since this boosts their long-term sales potential. A need for increased capacity may also affect the structure of new project contracts. This may lead to a smaller percentage of fixed-price contracts and a higher percentage of advance payments, which may affect companies' operational and financial risks.

Increased demand for manufacturing services in electronics

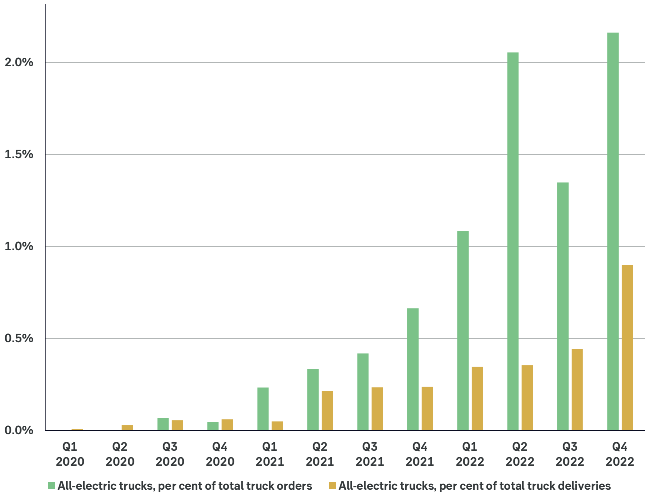
Contract manufacturers of electronics, such as Note, have seen growing demand for their services in recent years. An increased proportion of electronics in most products benefits this sector. Fast-growing companies prioritise investments in the development and sale of new products and choose to outsource production to external partners. Both Finnish-based Incap and Swedish-based Inission have also communicated a positive view of their future growth opportunities. A high degree of automation in production facilities and the relocation of production back to Europe have improved their prospects.

Volvo and Traton may benefit at AP Møller Mærsk's expense

Global supply chains as we know them today will be affected by fragmentation. If companies decide to increase value creation in every region to reduce disruption risks that affect deliveries from other parts of the world, this will change transport flows. It may mean that future economic growth will not affect the demand for container shipments from Asia to the rest of the world to the same extent as before, which may adversely affect the outlook for the Danish-based shipping company AP Møller Mærsk. Deliveries from China may be replaced by flows of goods from cost-effective countries close to the US and Europe, or by highly automated local production. One example of increased deliveries in nearby areas involves the Swedish logistics company Elanders, which noted at the time of its year-end 2022 report that it has seen vehicle customers buy more components from other European countries in order to reduce their dependency on Asia. Another example is that some computer manufacturers have announced that they intend to stop using chips made in China by 2024.

This should stimulate an increase in logistics operations such as road haulage, which offers greater flexibility than rail transport. Such a development would favour the outlook for heavy vehicle manufacturers Volvo and Traton (a subsidiary of Volkswagen that includes Scania). The environmental argument for rail transport is weaker if truck emissions are reduced, since the ambition of vehicle manufacturers and logistics companies is to sharply increase the proportion of electric vehicles (EVs) in their fleets. At Volvo, all-electric trucks accounted for 0.5 per cent of deliveries last year and 1.5 per cent of new orders. This is a positive trend from low levels; see the chart below. Volvo's ambition is for EVs to account for at least 35 per cent of its vehicle sales by 2030.

All-electric trucks as a share of Volvo trucks



Source: Volvo, Macrobond , SEB

The above chart shows all-electric trucks as a percentage of quarterly truck orders and deliveries at Volvo.

Increased automation

As we wrote in the last issue of *Investment Outlook*, improved technology is creating new conditions as more and more things are connected to sensors and software. This increases the potential for more cost-effective and less labour-intensive solutions. Two companies that are well positioned for the Fourth Industrial Revolution are ABB and Hexagon. Their products create the conditions needed for profitable investments in advanced economies, which are then able to compete with companies and regions that have more cost-effective labour.

Energy saving is an important part of reducing vulnerability

Along with a need for new energy sources and a transition to sustainable energy systems, energy efficiency improvements are also necessary to reduce vulnerability in Europe. With high energy prices, investments in energy-saving solutions are increasingly attractive. Swedish companies that will benefit from this include Alfa Laval and Nibe.

Increased tensions are already affecting companies today

Two Swedish companies that have been adversely affected by a shift in the retail and technology sectors between the US, the EU and China are the fashion retailer Hennes & Mauritz (H&M) and the telecoms specialist Ericsson. The position of these companies in China has deteriorated as a result. Ericsson has managed to offset this because Chinese vendors have largely been excluded from 5G networks in many Western countries; it has thereby enlarged its market share outside China. Another future risk is that global technology standards will be replaced by regional differences and regulations. That might increase Ericsson's development costs and/or decrease its patent revenue as well as its global economies of scale. Hennes & Mauritz has chosen to shift its purchases from areas where supplier corporate social responsibility (CSR) practices are questionable. This has had a negative impact on its revenue in China.

With increased global fragmentation, there is a risk that companies' economies of scale will decrease. That means a change in sales will affect earnings to a lesser extent when companies enter new markets or expand their range of products and services. With a larger number of regional production structures, adjustment capability may also be affected by changes in market conditions. This may result in continued problems like those experienced today by many companies that have needed to help certain suppliers hit by rapid cost increases and have had to raise the prices paid by their customers to avoid a decline in profitability. Overall, there is a risk that margins will be squeezed after a long period of growing profitability for many companies, which have benefited from strong global economic growth. Increased fragmentation is thus likely to have a generally negative impact on most companies with global market positions.