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# SUPPLY CHAIN RESILIENCE, FRIEND-SHORING, AND THE PURSUIT OF NON-ECONOMIC OBJECTIVES

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# Abstract





**S**upply and demand shocks from the Covid-19 pandemic, the intensification of rivalry between the United States and China, and the Russian invasion and ongoing war in Ukraine have further heightened geopolitical tensions in recent years. Reaction to these shocks has resulted in a new policy of ‘friend-shoring’ designed to increase economic resilience and reduce the vulnerability of supply chains. There are, however, serious questions around how effective the new policy will be at achieving these objectives. This

Policy Brief discusses the concerns about the potential of ‘friend-shoring’ to negatively affect world trade and welfare, retarding development prospects and exacerbating simmering tensions by fragmenting the world economy and reducing the legitimacy of the multilateral trading system. It advances recommendations that G20 policymakers may consider towards increasing resilience and minimising vulnerability of supply chains, without resorting to fragmentation policies.



# **The Challenge**

# **1**



## The move towards ‘friend-shoring’

Reaction to supply and demand shocks from the Covid-19 pandemic, the intensification of competition between the United States and China, and Russia’s ongoing war with Ukraine have elevated geopolitical tensions. A reaction to these shocks comes in the form of ‘friend-shoring’, which can be described as a relocation of the off-shored businesses and production processes to locations chosen based on political distance from a home economy rather than a geographical “distance/efficiency trade-off or a pure domestic industrial policy objectives.”<sup>1</sup> The pursuit of ‘friend-shoring’ now poses a serious threat to the strategy of economic development based on cost competitiveness and integration into regional and global supply chains. Governments are creating incentives and imposing restrictive measures to encourage the relocation of production out of the current hubs and into more like-minded countries in order to achieve what is being cited as greater economic resilience.<sup>2</sup>


This new approach to global trade and output was heralded by Janet Yellen,

United States Treasury Secretary, in a speech before the Atlantic Council in 2022, where she stated:

*“On some issues, like trade and competitiveness, this will involve bringing together partners that are committed to a set of core values and principles... Our objective should be to achieve free but secure trade. ...Favoring the friend-shoring of supply chains to a large number of trusted countries, so we can continue to securely extend market access, will lower the risks to our economy as well as to our trusted trade partners.”<sup>3</sup>*

In response to these incentives and policy nudges, companies are re-evaluating risks in foreign markets<sup>4</sup> and some are reconfiguring their supply chains, turning to what appear to be more trusted suppliers.

There are several challenges around this pursuit of friend-shoring and its potential to negatively affect world trade and welfare, to impact development prospects and to exacerbate simmering tensions even further. This Policy Brief discusses these challenges.



The authors are of the view that pursuing a policy of ‘friend-shoring’ on a broad scale to achieve economic resilience would be costly and misguided. It would be particularly damaging if it were to be advocated as a widespread option to influence the decisions of private firms in the global market.

### **Examining economic resilience and supply chain vulnerability**


Vulnerability in supply chains is characterised by their length and complexity.<sup>5</sup> The more vulnerable supply chains are also those which cannot be easily shifted between suppliers. Sensitivity is associated with the nature of the products in supply chains as characterised by advanced or cutting-edge technology (such as satellite components), products critical to essential electronics and defence production (dual-use products like semi-conductors, batteries or computer chips), or those in limited geographical locations (such as rare-earths).

At the firm level, companies participating in global supply chains have learnt over the past three decades that lean manufacturing—relying on extremely low inventory and just-in-time logistics

services for delivery—has allowed them to enjoy higher productivity, improved product quality, and lower financial costs. This changed during the disruptive years of the Covid-19 pandemic. Heightened exposure to the vulnerabilities in supply chains pushed firms to improve the economic resilience of their operations through new strategies aimed at the following:<sup>6</sup>

- Building redundancy into the supply chain through diversification of supply sources, maintaining safety stock, and having backup plans in place for critical components or raw materials.
- Adopting digital technologies such as real-time tracking, predictive analytics, and artificial intelligence to help anticipate and respond to supply chain disruptions.
- Collaborating with suppliers to help improve communication and information sharing and developing real partnerships (not just market relationships).

At the government level, discussions around economic resilience have tended to focus instead on national security.<sup>7</sup>



This has taken a disproportionate importance and overshadowed other dimensions of supply chain operations prioritised by firms. The national security prism has focused the attention of governments on those products which are manufactured in lengthy and geographically dispersed supply chains, or located in countries that are considered economic or political adversaries (or both). Today, the concept of ‘economic resilience’ is being linked to geopolitical allegiances. Risks to national security are considered to arise predominantly from high dependence on foreign suppliers, particularly ‘unfriendly’ countries, or from vulnerabilities in the supply chain itself.


Although there is no single definition of what makes a sector ‘vulnerable’ or ‘sensitive’, there is nonetheless a general convergence on a broadly similar list of products that have been targeted in legislative proposals and actions by several G20 members.<sup>8</sup>

To date, the legislation put into place to nudge ‘friend-shoring’ in specific products has been largely based on incentives in the form of a growing

recourse to subsidies and a resurgence of industrial policy.<sup>9</sup> If this approach does not succeed, however, the danger is that the list of perceived vulnerable and sensitive sectors will become more expansive and exercise an overly important influence on policy and economic decision-making. The key questions are how widely the net of national security (economic vs. non-economic concerns) should be cast as a justification for policy intervention to achieve what is perceived as greater economic resilience, and how this pursuit of friend-shoring may affect the world economy.

- **Potential costs of pursuing economic resilience through ‘friend-shoring’**

It is important to evaluate the costs of the new set of economic incentives being put in place in the name of economic resilience. This is a challenging exercise, since ‘friend-shoring’ is recent in nature and has not been in place sufficiently long to create measurable impacts. Friend-shoring is also difficult to assess since it involves efforts to change not only the production infrastructure but also innovation capacity.<sup>10</sup>



Despite these limitations, recent studies estimating the impact of ‘friend-shoring’ have shown that the pursuit of these policies could generate significant global income losses, largely driven by net declines in global trade.<sup>11</sup> As much as one-quarter of this dampening effect on trade would result from the disruption and reduced operation of global supply chains. Those countries that depend more strongly on trade would fare the worst, and those already in close geographic or strong trading relationships will be least affected.

These studies conclude that “renationalisation” of global supply chains does not in general make countries more resilient. Instead, they argue, trade can insulate a country from shocks when its foreign inputs are less disrupted than its domestic ones.<sup>12</sup>

Resilience is viewed as being enhanced by global sourcing, and vulnerability is increased when the number of sources is reduced.<sup>13</sup> The studies caution that economic resilience does not come from manufacturing products domestically, but through diverse international partnerships.<sup>14</sup>

Even for those products and sectors considered to be of strategic or national security importance, economists have cautioned against a wide-ranging sweep of controls and incentives to guide ‘friend-shoring’. They advise that it would be preferable to put in place stronger enforcement and monitoring of controls on selected, high-priority technologies and products.<sup>15</sup>

- **Systemic implications of pursuing economic resilience through ‘friend-shoring’**

Attempting to achieve greater supply chain resilience through friend-shoring will have not only impacts on cost, efficiency and development, but also systemic implications. These will affect individual countries as well as the legitimacy of multilateral institutions, especially the World Trade Organization (WTO). For all of the reasons discussed so far and in the succeeding paragraphs, the authors are of the opinion that the pursuit of ‘friend-shoring’ is not the best solution to ensure economic resilience and supply chain robustness and flexibility. Though it may be attractive in the context of the pursuit of non-economic objectives, it





is a dangerous strategy that will have long-term impacts. Potential systemic consequences from ‘friend-shoring’ include:

**i. Fragmentation among trading partners and increased geopolitical tension**

‘Friend-shoring’ succeeds by carving up the world trading system and reconfiguring supply chains to consist only of firms producing inputs from like-minded trading partners. It elevates the primacy of politics over that of comparative advantage and results in fragmentation of the global economy along lines that are politically drawn rather than economically derived. Unable to invest and source where their production would be most cost-efficient, firms are ‘encouraged’ or constrained to carry out their activities in second-best locations. Admonishing firms to take “non-economic variables” – economic resilience and national security – into account in their production calculus will result in more security at the cost of less efficiency and higher prices.<sup>16</sup>


It is also important to note that ‘friends’ may be temporary and not permanent,

depending upon the political alignment of the moment. Changing such alignment due to criteria that are not grounded in economic fundamentals risks constant disruption for private sector actors and reduces the predictability and stability of their planning horizon and increases search costs.

The delineation of the world into separate camps may increase geopolitical tension, which is already running high. It may also have the unfortunate effect of heightening the risk of future armed conflict, as previously close trading partners become accustomed to view themselves in opposing and irreconcilable camps.<sup>17</sup>

**ii. Greater use of subsidies and industrial policy**

Subsidies are already being used more than any other policy instrument in the global economy. Recourse to subsidies has nearly doubled compared to other policy instruments combined, over the period 2009-2021.<sup>18</sup> It is estimated that between 70 and 80 new subsidy measures are recorded every week into the Global Trade Alerts database.<sup>19</sup> Subsidy use has



accelerated over the past two decades and is reaching unprecedented levels in many economies.<sup>20</sup> The growing use of distortive subsidies alters trade and investment flows and contributes to global trade tensions that are harmful to growth and living standards and diminish support for open trade.

The ongoing pursuit of industrial policies to promote ‘strategic’ sectors attempting to incite firms to move production and investment to friendly countries will likely bring into play even more subsidies (potentially leading to a ‘subsidy war’). Without doubt this will distort international competition and undermine the G20 objective of strengthening support for freer and fairer trade. Greater recourse to subsidies also puts smaller and less financially strong developing countries at a disadvantage, as they cannot afford to compete against industrialised countries with more resources.

### **iii. Loss of legitimacy for the WTO**

‘Friend-shoring’ derails the WTO by reducing its legitimacy in trade relations and reliance of its members on the multilateral trading system. It places

emphasis on bilateral or small-group relationships for trading partners with the purpose of isolating ‘non-friends’.<sup>21</sup> Often these ‘friend’ partners are also strategic partners in military alliances. This practice serves to undermine multilateralism, which is already under severe stress. Those who suffer the most from the loss of WTO legitimacy are the smaller nations that rely on the rules of the multilateral trading system to protect their interests against larger trading partners (moving toward power-based system).

The lack of compliance with the WTO’s main principle of non-discrimination is already pronounced. A pertinent study indicates that more than half of world trade in goods today is subject by G7 and EU members to some type of policy intervention that has tilted the commercial playing field in favour of local firms and exporters. Policy interventions taken by China, India, Russia and Turkey in favour of local firms now affect two-thirds of world goods trade.<sup>22</sup>

Closed agreements with “friends” can only be achieved with interventions designed to shift economic outcomes in

the direction dictated by foreign policy, not by the commercial considerations on which the General Agreement on Tariffs and Trade (GATT) / WTO was founded. Such interventions will run counter to WTO disciplines through recourse to discriminatory tariffs, subsidies,


and regulation.<sup>23</sup> The less attention members pay to existing WTO rules, the less will be its legitimacy, making the success of efforts to negotiate much-needed additional rules to modernise the trading system all the more difficult to achieve.



# **The G20's Role**

# **2**






**A**s the premier global forum for discussing economic issues and comprising the world's most important, albeit not necessarily 'like-minded', economies, the G20 has the role of enabling those economies to find ways of crafting an understanding around thorny issues and to outline a path forward that does not derail the rest of the world.

The role of the G20 in this context is to urgently and carefully evaluate the causes for the pursuit of 'friend-shoring' and to debate in an open way the costs and benefits of this strategy currently in vogue. The recommendations in the following section may help provide a way forward as the current obsession with de-coupling may end up doing more damage to the world economy than the 2008/9 global financial crisis.



# **Recommendations to the G20**

# **3**



**T**his Policy Brief offers the following recommendations to G20 governments as they strive to improve economic resilience and robustness and flexibility of their supply chains.

1. Review existing regulatory frameworks to ensure that private firms can conduct their supply chain operations in the most flexible and efficient manner possible.
2. Limit the number of products deemed to be strategic or of national security interest and singled out for special incentives or screening policies to the minimum.
3. Conduct an annual discussion in the G20 on the impact of ‘friend-shoring’ policies. Undertake a cost-benefit analysis of those policies in place to evaluate the net effects of their planned or desired objectives.
4. Work together as the G20 to rebuild trust in the multilateral trading system, particularly through initiating an effort in the WTO to discuss the expanded recourse to subsidies and updated rules for their use.


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## Endnotes

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