

“Reshaping Global Industrial Chains over Trends and Cycles: Options for China and the World Economy”: Some Hypotheses from a European Perspective

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Kiel, December 16, 2021



Where do we start from?

- Over the recent past, world trade growth was driven mainly by trade in intermediates rather than by final goods trade
- Without trade in intermediates, trade growth would have been even fallen back behind growth of world production since the 2008 crisis. With trade in intermediates, trade and production growth are at similar levels
- China has been a leading participant in supply chains from the downstream side, both in domestic market orientation (eg. manufacturing of energy products) as well as in world market orientation (the well-known iphone “made in China” example with relatively low local content)

Where do we start from?

- The main hypothesis established in the past argues that supply chains are lengthened in upswing periods (mainly due to labour market bottlenecks) and shortened in downswing periods (due to rising costs of trade). This hypothesis will have to be reviewed in times of a simultaneous emergence of erratic supply and demand shocks during the pandemic. The pandemic requires a totally new look on cyclical factors driving world trade in intermediates.

- The three main trend factors (demographics, technology (digitalization), climate change) point to a rising importance of the “safety” argument sailing under different flags.
- Under **demographics**, an aging and richer society will shift its demand structure from low-skilled to high-skilled manufactures and from manufactures to services, both from unsafe to safer countries of origin verifiably produced under benchmarks of sustainability (home bias). Benchmarks are set by the demand side. Result: Supply chains will become “more resilient” and- in case of doubt - will become shorter. Here, more safety means higher resilience and less participants.

- **Technology** will reduce trade costs. Yet, when barriers to technology transfer between suppliers and buyers emerge (due to unevenness in digital infrastructure endowment between countries), supply chains will become regionalized with regions defined by intra-regional similarity in safety standards. Technology will also substitute goods trade for services trade with conditions of minimum safety for consumers (eg private data protection). Result: Supply chains must not necessarily become shorter but are likely to become regionally more clustered.

- **Climate change** and the fight against global warming will favour horizontal over vertical foreign direct investment with the former supplying the host country market and the latter exploiting cost advantages for further exports. Usually, horizontal FDI stimulates trade in intermediates between home and host country while replacing finished goods trade. Yet, it is possible that together with the two other trend factors, FDI in total will substitute for trade and again raise local content at the expense of trade in intermediates. Here, safety means substituting long-distance trade for short-distance trade

- The main hypothesis from the three trend factors: Supply chains will be shortened and will be concentrated within regions with similar benchmarks of safety.

- Cyclical factors are subject to three drivers: the fight against the pandemic, trade policy conflicts and rising systemic rivalry. Here, safety is defined as national security.
- **The pandemic** has opened the window for stimulating global supply chains in intermediate goods for producing pharmaceuticals. But it has also impeded finished goods trade because of export restrictions on vaccines.

- The pandemic has also led to a number of supply shocks when production capacities fell victim to covid-19 or when transport networks got interrupted because of closure or congestion of container ports
- **Trade policy conflicts** distort bilateral trade flows (such as the Sino-US trade deal I phase) and discriminate against workable supply chains.
- If conflicts escalate to **systemic rivalry**, the financial sphere will be included thus forcing investors in supply chains to tap selected financial markets within the home sphere instead of global financial markets

What is in for China and Europe as Home and Hosts of Supply Chains?

- Both China and the EU will aim to intensify the resilience of their home regions against trend shocks and/or cyclical shocks from outside the regions.
- China will use its leading role in RCEP to test preconditions for future membership in CPTPP as long as the US abstains from re-entry into the former TPP. As CPTPP is much more about sustainability and safety than RCEP, Chinese entry into negotiations on CPTPP membership would be a game changer for transpacific supply chains to be more compliant with more precaution in global trade. This might be especially important for Chinese state-owned enterprises as parts of global supply chains.

What is in for China and Europe as Homes and Hosts of Supply Chains?

- The EU will head for completion of the single market as its main asset and at the same time underline its high priority to more resilience by establishing different tools: an “anti-coercion instrument”, the preparation of the Carbon Border Adjustment Mechanism, the efforts to form a “Climate Club”, and a regulation for due diligence in supply chains controlled by EU companies against direct and indirect suppliers from third countries. The latter will be more far-reaching than due diligence laws from EU member states as it will cover labour rights, protection of the environment and good governance.

- Both trend and cyclical factors act against a further “slicing up the value added chain”. It is very likely that the length of the chain and the origin of its various links will be reviewed and changed in line with these factors.
- In case of rising systemic rivalry, the financing of new supply chains can become a limiting factor if access to finance is made contingent on compliance with national security or safety targets which may strongly differ between China, the US and the EU

- The new playing ground for rules about supply chains and their political and economic environment is likely to shift from trade (where the multilateral rulebook is ever more porous) to FDI (where there is so far no rulebook).

I look forward to the discussion!



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