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A New Geopolitics of Supply Chains

The Rise of Friend-Shoring

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A succession of disruptions to world trade have put the reorganisation of international supply chains high on the political agenda. The difficulties began with the trade war between the United States and China, deepened with the Covid-19 pandemic and culminated in the sanctions and export controls imposed by Western countries after Russia's invasion of Ukraine. The increased risk of interruption of supplies forces businesses today to price in political factors and respond to political demands. However, realistic timeframes for reconfiguring supply chains are largely incompatible with the rapid responses expected by political decision-makers, especially where chains are long and complex. A process needs to be developed for dealing more effectively with political supply chains risks. It should be transparent for all involved.

The consequences of the Covid-19 crisis, growing tensions between the West and China and the war in Ukraine have placed the question of reorganising international and global supply chains firmly back on the political agenda. The further the economic sanctions are expanded, the more strongly trade relations become an instrument of foreign and security policy. The idea of free trade as an intrinsic value falls by the wayside. Now, staking out spheres of influence and assessing the reliability and trustworthiness of suppliers and countries is the order of the day. That is the background to the recent recommendation by US Treasury Secretary Janet Yellen to pursue "friend-shoring" by shifting supply chains to "trusted countries". This, she said, will allow us to "continue to securely extend market access" and "lower the risks to our economy as well as to our trusted trade partners" Yellen's Canadian counterpart Chrystia Freeland took up her proposal, welcoming friend-shoring as a "new norm" that "may require some new institutions, some new relationships". This pursuit of political convergence in the guise of shifting supplier relationships to states espousing similar values has been taken up in the European context, for example in the European Commission's Strategic Foresight Report 2022. The key concept of "secure trade" calls into question the multilateral system of the World Trade Organisation. WTO Director-General Ngozi Okonjo-Iweala criticised this trend towards fragmentation of the world trade order as a "wave of protectionism". Voices from the Global South

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also reject friend-shoring on principle, arguing that it would exclude poor countries even more strongly from international trade, fail to provide them with income and employment, and endanger their internal stability.

Geopolitical divides in the supply chain world

Friend-shoring builds on an open partnership model, encompassing those states that share the American understanding of open markets, while at the same time implementing labour and environmental standards. That has been expedited by Europe's decision to terminate economic relations with Russia. It raises the prospect of the emergence of a new trading bloc, composed of democratic states pursuing economic and regulatory convergence. What that means for supply chain governance is the introduction of a new and strongly geopolitical facet into the broader discussion about geographical "re-shoring" (relocation to the home country) that had to date encouraged diversification in a more neutral sense. This applies especially to strategic sectors such as aerospace, automotive, micro-electronics, medical devices and pharmaceuticals, but also to mineral, energy and agricultural resources and their processing.

Yellen's proposal introduces the geopolitical dimension of "trusted trade partners" into a debate that has hitherto concentrated on the operational reliability of supply chains. In other words, the political convergence outlined above comes on top of the existing criteria of efficiency, sustainability and resilience. The proposed reversal of corporate location policies and the shortening of supply chains will be financially costly and will require considerable time, especially with complex supply chains. Thus it is estimated that up to 26 percent of global exports could potentially be relocated in the next five years, amounting to up to US$4.6 trillion. However, the associated corporate decisions now have to take increasing account of political aspects that they previously preferred to ignore. Assessing the profitability of friend-shoring involves a strategic reorientation that could mean a far-reaching reconfiguration of the existing supply chain networks. Achieving that will inevitably demand a great deal of time and financial investment.

Concretely it would mean abandoning the simple logic of "off-shoring" (relocating production abroad) and replacing it with a flexible mix of "near-shoring", "re-shoring" and "friend-shoring". Depending on the availability of production factors and locations, such a mix would lead to a modular reconfiguration of the various segments of a supply chain. It will be imperative to contextualise the specific conditions at each stage of the supply chain from a strategic and operational perspective.. That can only be achieved if state and corporations work hand in hand. The final destination of efforts to establish "secure" supply chains for strategic goods and services would then be a geopolitical reordering of the world, dividing it into "North-North" and "South-South" supply chains. In that case it would be expedient to gather a coalition of allies.

However, given the global geographical distribution of resources, it is questionable whether such a model would be viable. It must be expected that applying such a logic would lead to massive disruption of trade flows, bringing with it enormous price increases for consumers.

Operationalising political convergence

The proposal to pursue friend-shoring draws supply chains into the sphere of geopolitical rivalry and the division of the world into free-market democracies and allies of the authoritarian regimes of China and Russia. One central motive for friend-shoring is the desire for greater independence from suppliers whose autocratic disposition creates dangers of political blackmail and economic coercion. If vulnerability to interdependency is reduced, it is hoped, supply chains will become more robust and their participants less exposed. Ultimately it is a means to protect global supply chains from external disruption and economic coercion. The EU's ambitious plans to invest €43 billion in its semiconductor industry and the US CHIPS Act to boost domestic production are both clearly "re-shoring" endeavours. However, problems over availability of raw materials, dependency on imports and the cost of labour place limits on the possibilities to replicate such endeavours. Here there is no getting around China, which is by far the most important producer of textiles, electronics and many raw materials. China, as a node in the system of global supply chains, has been able to expand into upstream production stages in the automotive and textile sectors, as well as in raw material processing and control of rare earths. The flip side is a negative record on observance of human rights.

It is as yet unclear how far the friend-shoring process is supposed to go. Is the point merely to encourage businesses to locate their production primarily in "trusted" countries? Or is there to be a prioritisation according to the strategic value of the goods and services? How can political convergence be handled as a manageable criterion? Conflicts are inevitable. Businesses strive for efficiency and scale effects, while political decision-makers prioritise securing access to important products. So what weight is assigned to democracy, human rights and sustainability when judging the "trustworthiness" of states? Oversimplification is not helpful here. Instead, states pursuing the friend-shoring concept need a balanced assessment of interests that takes into account all the criteria of sustainability. This also applies on a global scale with respect to potential beneficiaries of relocation of production and employment.

All the signs certainly point to change. Consulting firm Kearney's 2021 Reshoring-Index reports that just 8 percent of manufacturing executives were not "considering reshoring manufacturing operations". 47 percent had "already reshored some manufacturing operations to the United States" in the past three years and another 29 percent had decided to do so within the next three years. Note that the survey was conducted before the invasion of Ukraine and resulting energy crisis.

So the United States wants to reduce its dependency on authoritarian regimes like China for essential products, above all rare earths, electronics such as semiconductors and other goods with military uses. To that end it is seeking closer cooperation with South Korea and Japan. Europe in turn is looking to decouple itself from Russian suppliers of crucial resources, especially energy, grain and fertiliser.

It becomes problematic, however, if all the Western states seeking "trusted" sources turn simultaneously to Indonesia, Malaysia, Vietnam and other countries in the Indo-Pacific region, or in Europe's own region to Bulgaria, Romania and the Mediterranean states. Simply shifting factories, jobs and investment en masse to those countries is not a terribly promising strategy. While it would achieve a degree of geographical diversification of global supply chains, it would not necessarily make them more resilient to external shocks. Many of the transport routes would be largely identical and subject to massive disruption through the same events, be they tropical storms, political blockades or bottlenecks in the Suez Canal. Nor would it eliminate political risk factors affecting the new diversification partners in South East Asia, or China's regional hegemony. If operationally and socially robust production cycles are to be created, they will have to be embedded in a more strongly political orientation on Western values and the corresponding behavioural norms, in order to reshape corporate behaviour. Moreover, a classification of particular states as "trusted" cannot be expected to remain constant over time. Such black-and-white thinking ignores the realities of trade and economic policy, and the shades of grey that tend to predominate there.

Nevertheless, this line of thought is gaining ground in the political discussion.

It also plays a role in the Partnership for Global Infrastructure and Investment announced at the G7 summit in Germany at the end of June 2022. This promises almost US$600 billion in strategic investments in global infrastructure over the coming five years, and will support friend-shoring. This Western alternative to the Chinese Belt-and-Road-Initiative is intended to demonstrate economic and political strength and contain China's plans.

Geopolitical reconfiguration of supply chains

The demand for political convergence shifts the emphasis of supply chain governance to the producer side, especially where critical raw materials are concerned, while tracking, traceability and auditing become less central. Because the supply of inputs and precursors from abroad is no longer reliable (or desired) a reorganisation of production is on the agenda in many industrial and agricultural sectors. The geographically highly dispersed manufacturing enabled by low transport costs now appears increasingly disadvantageous. In addition to doubts over the dependability of supplies and suppliers, once reliable logistics relations have been affected by port bottlenecks and restrictions at particular production facilities, for example through Covid-19 outbreaks.

Given the number of economic transactions and steps involved in the production of goods, such a shift will mean reordering the relationship between private-sector business decisions and government regulation. This applies in particular to the question of where production facilities can and should be located, but also to the classification of goods and services as strategically important. Due to their central role in the shaping of international manufacturing networks, lead firms influence the benchmarks of any economic transaction — price, volume, number of suppliers, their qualification — as well as characteristics the suppliers should possess aside from the question of price, such as quality, labour and environmental standards.

The way this plays out will differ between producer- and buyer-driven supply chains: The role of lead firms is stronger in the producer-driven supply chains found in capital-intensive sectors such as the automobile industry, where the need for great technological expertise and enormous investment function as the main entry barriers and cement the positions of the biggest manufacturers. Producer-driven supply chains are therefore characterised by strong vertical integration. The buyer-driven supply chains found for example in agriculture and in the fashion, footwear and toy industries, on the other hand, are characterised by labour-intensive processes run by outside contractors. In those sectors the entry barriers are market information, product design, and marketing/advertising.

Both models are based on an outsourcing logic that seeks to relocate cost-intensive and labour-intensive segments of the production process to regions of the world with lower cost conditions. While the academic debate has come to regard the distinction between producer-led and buyer-driven supply chains as largely outdated — tending instead to speak of modular organisation of supply chains — the distinction gains a new meaning under the strategic aspect of security of supply. If supply chains are to be reorganised for geopolitical reasons, the question of how central manufacturing steps need to be reconfigured and relocated in order to satisfy national interests will have to be clarified.

This places front and centre those actors that possess far-reaching coordinating and coordinating functions in the supply chains: the lead firms with their great market power. Decisions and agreements made at the interface between the lead firms and their first-tier suppliers have great influence on and consequences for a broad spectrum of actors further upstream. The leading companies are now in the first place required to rethink and increase their strategic stockholding. They are also seeking to reduce possible supply bottlenecks by diversifying their production facilities across multiple countries and to increase their flexibility by improving the substitutability of inputs. However, such measures are always also associated with political judgements about the host countries, for which businesses now expect political guidelines. In order to preserve the viability of global supply chains, new forms of coordination between the public and private sectors are therefore needed.

Orchestrating supply chain governance

"Sovereignty over supply" has become the watchword of the debate, which has moved beyond the idea of achieving technical sovereignty through decoupling from China. Now, the thrust of the discussion has been reversed: Where once businesses resisted regulatory intervention in supply chains, they now call for state instructions for organising robust production processes. To that extent they have become victims of their own decisions, which were motivated solely by cost efficiency and externalised environmental and social costs to the detriment of the producing countries. Not so long ago European and German regulation of due diligence was regarded as unwarranted interference; now industry calls for state support and guarantees for reconfiguring its supply chains.

The search for greater autonomy is interlaced with expectations of possible gains in autarchy. But the underlying thinking is a dead end. The question is ultimately how the innate risks and the reliability of the suppliers are assessed. Here the complex structure of supply chains must be taken into account, along with the associated cascading effects. Operational questions are therefore also on the agenda, for example the possibility of shortening supply chains, expanding vertical integration by taking over suppliers, or increasing stockholding.

Prioritising capital efficiency led many manufacturers to employ subcontracting to lower production costs. Yet minimising costs is incompatible with the expense of investment in duplicate facilities, and with the challenges associated with distributing production volume across multiple locations. While businesses have often sharply rejected state intervention in operational affairs, the importance of eliminating vulnerabilities in logistics, ensuring security of supply and complying with due diligence now forces them to rethink. The criterion of political convergence requires that supply chain governance be "orchestrated" between state and industry. This can range from new trade agreements to the creation of a "trusted suppliers" platform. There is also the question of who covers the additional costs. Many decision-makers are sceptical whether businesses or consumers will really be willing to bear the structural costs incurred in relocating production and the friction costs of reconfigured supply chains.

The shift to new production locations can be orchestrated best in and in coordination with lead companies that shape producer-driven supply chains, with capacity to regulate, options for rapid action, and a need to secure strategic products and segments. Because they control the nodes of their supply chains, these lead firms possess considerable leverage over the relationships within the entire chain.

Although recent research demonstrates that such multi-stakeholder processes involving state(s), businesses and civil society are not per se more effective in enforcing standards, they do enjoy much greater legitimacy. This applies not least with respect to the representation of producers and NGOs from the Global South, which is vital for local implementation of environmental, social and human rights standards. Here the question is above all how the lead firms will distribute the accruing costs. Studies suggest that these are often unloaded onto upstream suppliers. That places a great burden on small and medium-sized companies in supplier countries and forces many of them out of the supply chain altogether. This is neither sensible in development terms, nor will the governments of the affected countries tolerate it in the longer term. State subsidies can only compensate part of the cost of resilience and convergence. Instead one should concentrate on the successes achieved through orchestration by "lead firms" with states taking supporting measures. This could also spur other branches to take similar action.

Orchestration of supply chain governance demands multiple modifications to process and structure, which need to be taken in hand as rapidly as possible within and between businesses. For example strategic goods need to be selectively secured against concrete identified risks by increasing stockholding. Additionally it may be advisable for manufacturers to take over their suppliers. Guarding against supply chain risks and assessing transport security are on the agenda, along with corporate enforcement of environmental and social standards and the suppliers' obligations to deliver.

Ultimately all this touches on economic and regulatory questions that also relate to the degree of concentration in a sector. One of these would be the expectation that successful orchestration will lead to increases in coordination problems and transaction costs. Firms with a dominant role will be affected most: major supermarket chains, pharmaceutical companies, commodity traders, but also seed producers.

Ever more leading companies are based in countries of the Global South. There, efforts to found state-owned corporations to manage and exploit national resources can currently be identified, seeking to bolster their sovereignty and political autonomy. That is likely to make it harder to enforce sectoral and political standards and transnational regulations, because due diligence arrangements heighten the national sensitivity of questions of manipulation of trade law and accusations of trade restrictions. There will therefore be a need for governmental agreements with these "lead firms", in order to provide political conditions for the actions of businesses. Here it will be necessary to weigh the strategic significance of the respective sector or segment, because across-the-board regulation is likely to remain the exception. Processes orientated on local ownership thus become more important than classical instruments guided by compliance requirements. This orientation is not least a consequence of individual countries in the Global South agreeing to establish new regional supply chains under their own standards.

Political geography and legislation

The spatial reordering of supply chains under the criterion of "political convergence" requires a reconfiguration of the geography of production, transport and consumption. It must be assumed that the maxims of friend-shoring and security of supply will bring regions closer together and cause logistic and operational hubs to be reconfigured. As supply chains are reconfigured, global competition for cheap wages, appropriate production and transport infrastructures, and tax incentives are likely to play an important role again. The more strongly supply chains come under the sway of geopolitical rivalry, the weaker will be their economic determination. There are various dimensions to the politicisation of supply chains. The role of uncertainty and risk factors grows in line with their massive implications for economic activity and political stability. Guidelines will need to be laid down for partners (structures), be it in the scope of resource partnerships, in the establishment of new consortia or through acceptance of central rules and standards. The distribution of the costs of a geopolitically driven reordering of supply chains is a central point of discussion that needs to be clarified between state(s) and businesses.

A first attempt to coordinate international action was undertaken in June 2022 by ten Western states and the EU, in the form of the Minerals Security Partnership (MSP). This seeks to ensure that critical minerals like cobalt, lithium and nickel are extracted, processed and recycled in a manner that enables the member states to share their geological resources with "friendly" states. This cooperation seeks to establish robust and responsible supply chains for raw materials through public and private infrastructure investment, in a form that also meets the requirements of the EU's Green Deal.

The MSP links the production, processing and recycling of critical raw materials. Its members — Australia, Canada, Finland, France, Germany, Japan, South Korea, Sweden, the United Kingdom and the United States — include both resource-poor and resource-rich states. A supply chain bloc formed by these countries would thus come very close to the friend-shoring concept. As such, these supply chains would function without the involvement of China, which currently plays a central global role in the processing of the aforementioned minerals. Establishing such a thoroughgoing supply chain from mining through refining to manufacturing and recycling would thus be a first step towards reordering global supply chains to Western standards, including observance of climate standards and guaranteeing security of supply with critical raw materials. The degree to which the participating states are willing to cooperate is likely to decide whether this step towards geopolitical separation of supply chains is actually realised.

Until then countries will continue to pursue national paths to security of supply. But the priorities should not be entirely turned on their head. In view of raw material shortages and the associated restructuring of supply chains, there have already been calls to suspend the due diligence legislation. But that would not be conducive to a reorientation of the political geography of the supply chains. Instead it must be ensured that the statutory requirements are integrated into the corporate processes and orientated on reducing human rights risks. Regulatory trade-offs between efficiency, sustainability, resilience and political convergence need to be avoided. Corporate responsibility must prevail precisely in the conflicts of goals between the different demands. Otherwise significant disruption of an economic and political nature must be expected. Stakeholder value possesses special weight in complex structures like supply chains and must be made visible. If the reconfiguration of supply chains is to be successful, government will have to support individual companies and the economy in general and on the road to realising this potential.

Ultimately the possibility to build coherent blocs (along the lines of the MSP) will remain limited. And new provisions of competition and trade law are likely to increase the complexity of creating geopolitically "secure" supply chains.

Prof. Dr. Günther Maihold is Deputy Director of the SWP and leads the SWP contribution to the research network on Sustainable Global Supply Chains, which is funded by the German Federal Ministry for Economic Cooperation and Development.

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