Deglobalisation ahead? The pros and cons of reshoring

Recent geopolitical events have kickstarted a shift toward more self-sufficiency. Headlines about the end of globalisation are making the rounds. But is deglobalisation really the answer to current supply chain problems? We don't think so

Conditions for international trade remain very tough

Trade has adapted to shock after shock

Things haven't been easy in the world of trade for some time now. Former US president Donald Trump's trade war introduced tariffs on one of the world's major trade flows, between the US and China, as well as destabilising the rules of world trade. Then came the disruptions to production and shipping due to the Covid-19 pandemic, which resulted in shortages and inflation around the world. Around these shocks, trade flows have adapted. While China-US trade is down, both countries have increased trade with partners across the rest of Asia to source inputs and as markets for their goods. During the pandemic, global production started to shift to keep exports flowing even as Asia, Europe and the US were locked down.

The pattern of demand during the pandemic was drastically different to normal years, with a jump in demand for protective equipment, food, and products for the home, including electronics. World trade responded, changing the pattern of goods exports to match. But struggling terminals at ports and a lack of availability of containers led to delays for these products and others as the pandemic progressed, as well as much higher shipping costs. The extreme congestion in container shipping has prevented goods from getting where they need to be during the pandemic and into the recovery phase, with delivery delays and higher costs for shippers and consumers leading to a renewed focus on whether their globalised supply chains entail too much risk.

Continuous supply uncertainty keeps the focus on reshoring

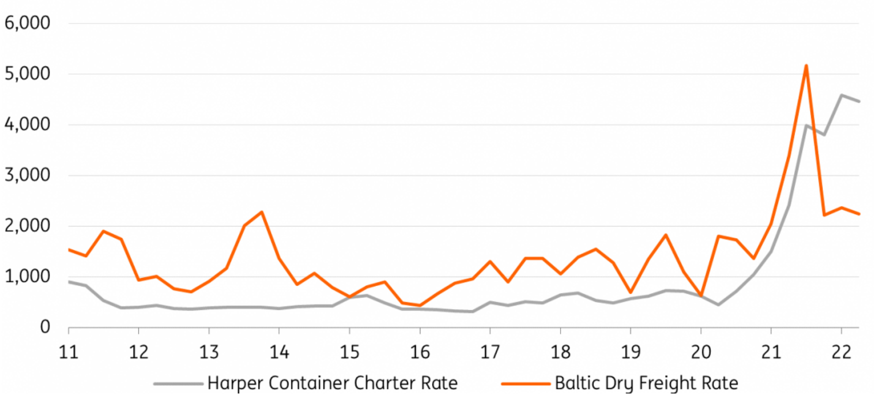
Research has consistently found that, as a way of reducing risks, offshoring beats the alternative of reshoring supply; for countries, and for firms, it is better to diversify suppliers. The experience of the pandemic showed how this can be true, with different regions going into lockdown at different times. Asia, which opened earlier, became an important destination for exports from all countries. While China continues to pursue a zero-Covid policy, sourcing from outside China and using ports in the rest of Asia can help to reduce unexpected delays.

But the risks of sourcing overseas are a less immediate concern than higher shipping costs, which might tip the balance in favour of sourcing from nearby.

And shipping costs are not the only trade costs which are rising. Increasingly, policy is adding to trade costs. The EU's new Carbon Border Adjustment Mechanism will add the equivalent of a trade tariff to reflect the emissions embodied in imports from outside the EU. And, less visibly, public subsidies to firms and industries which were widely used during the pandemic have changed the relative costs of production at home and abroad. The wind has changed from one which was blowing globalisation along at an ever-faster rate, to a headwind, making short-term costs a big part of sourcing decisions.

Some of the higher costs are temporary. In shipping, a significant number of new container ships are being built, new port capacity being built is coming onstream weighing on freight rates, and pandemic subsidies are being unwound. On the other hand, some of the headwinds are here to stay. The policy uncertainty which spiked during the trade war is subsiding in favour of a new era of more defensive trade policy that may make tariffs and sanctions more readily used. Reviews in the EU and US of 'strategic' supply chains, such as for protective equipment, may lead to domestic productive capacity and inventories being increased, and in the longer term, less trade in these goods.

Shipping rates have seen major and sustained increases



Source: Macrobond

When one door closes, another one opens – more diversification ahead

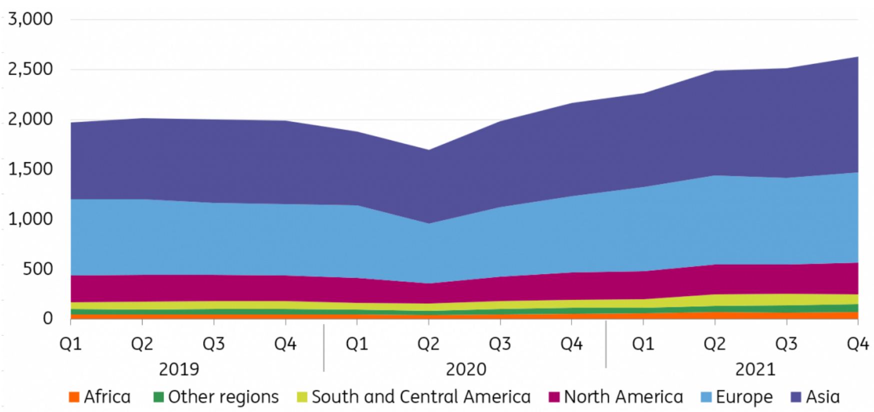
However, due to the multiple crises that we've seen over the last couple of years – trade wars, the pandemic, the war in Ukraine – completely new trade opportunities have opened up which in turn could boost global trade again. Despite headlines about reshoring increasing, there is not yet much evidence of companies bringing production back home. Instead, there is evidence of more diversification.

In the US, for example, companies increased their import share of manufactured goods from Asian countries in 2021 for the second year in a row, reversing the dip in 2019 following the US-China trade dispute, according to Kearney's Reshoring Index. Although the war in Ukraine is an additional factor for companies reconsidering their way of doing business, Covid should have been enough of a driver to shift operations in light of the sharp cost increases. Apparently, however, it hasn't been enough to get US businesses on the reshoring track on a large scale. While construction activity for manufacturing facilities is on the rise in the US, it concentrates on areas deemed critical, such as microchips or certain commodities, and might not even show up in trade numbers for the time being.

When we also look at the trade in intermediate goods, world exports increased by 21% year-on-year in the fourth quarter, continuing its upward trend after a dip in the first half of 2020 due to the Covid-19 crisis.

No sign of weakened intermediate goods trade

World merchandise exports of intermediate goods by region (US$bn)



Source: WTO, based on Trade Data Monitor

Those numbers, however, only account for most of the Covid-19 crisis and do not yet reflect the impact on supply chains from the war in Ukraine. We don't know yet how exactly the war in Ukraine will change global trade and in which direction. We believe, however, that it will lead to permanent changes in trade flows. We expect trade flows from Russia to Western countries which have sanctioned Russia to be ceased permanently, with some Asian, African and Southern American countries compensating for the loss of Western exports. As mentioned above, however, this might open up new trade opportunities, ultimately leading to a boost in global trade.

Furthermore, infrastructure investments do not speak in favour of less internationalisation. On the contrary, with the G7 trying to put a planned $600bn investment response against China's Belt and Road Initiative, the infrastructure gap in developing countries is supposed to be reduced, in turn facilitating trade with those countries. As the IMF has pointed out, upgrading and modernising port infrastructure on key global shipping routes – and key infrastructure in general – will reduce global chokepoints. For the Suez Canal, for example, several development projects are currently underway, also focussing on green investments, turning the canal into a 'green canal' as of next year. A recently signed cooperation agreement between the Suez Canal and the Panama Canal is another example of supporting smooth global supply chains. New transportation roads such as the International North-South Transport Corridor (INSTC) facilitating trade between India, Iran and Russia is an example of how new trade opportunities are still being sought. Regional trade agreements such as RCEP within the Asia-Pacific area or AfCFTA promoting intra-African trade will continue promoting inter- and intra-regional trade.

'Friendshoring' – political pressure as a major driver for reshoring activities?

The 'friendshoring' trend that has emerged in recent years is likely to continue, with the supply chain due diligence act prepared by the EU, as an example, speaking in favour of this concept. Political or public pressures might rise, which could lead companies to relocate their operations despite rising costs and reduced competitive advantages, which have to be offset by government incentives to financially support reshoring, offering preferential tax treatments or implementing trade restrictions. Public condemnation for doing business in 'unwarranted' countries could lead to more trade relationships with 'friendly' trade partners sharing similar values and ethics. However, 'friendshoring' works in both ways, meaning that Russia, for example, is also already looking for other 'friendly' destinations than the West, reorienting exports towards China, India, and so on.

Overall, this rather speaks in favour of more diversification. Less sourcing from one country, more sourcing from another. Also, don't forget that crucial commodities, in particular, are extremely difficult to substitute. Although the appetite for home-grown components is rising, e.g. in the eurozone, the US and China, and although it would be favourable to be less reliant on certain import products, such as rare earths for the EU, for example, having only minimal resources which have to be extracted at immense costs is not enough to become self-sufficient and stop commodity imports completely.

In the end, it still boils down to competitive advantages

Why are we likely to see diversification rather than reshoring? Relocating business operations still boils down to whether companies have a competitive advantage in relocating or not. If sourcing production closer to home increases production costs, but does not come with an advantage, companies will be reluctant to relocate their business operations on a large scale. Instead, it makes sense for companies to diversify suppliers in more than one location to cover the security aspect.

With a pronounced lack of skilled workers around the world, relocating isn't the easiest thing to do in practice, although home office regulations make employment shifts easier for some occupations and industries. But high inflation rates build up pressure on wages. In the US, in particular, wage pressures are immense, widening wage gaps with other countries. In the past, wage gaps narrowed between the US, the EU and China, making labour costs a less relevant factor for relocation considerations into these countries. However, with inflationary pressures leading to widening wage gaps, wages will once again play a bigger role in reshoring considerations.

Although the share of transport costs in total goods value has increased significantly – up from a few per cent of total costs on average per container load – and is not expected to return to previous levels, it's still not a massive factor in most cases apart from the impact of delays. Labour cost differences will often influence the decision more strongly.

Don't forget about the customer

Lastly, don't forget about the customer. Although the public might condemn some business actions, with the price increases that we have already seen as well as with wages which do not track inflation, we will reach a point where things are simply unaffordable. Companies already report that it's getting harder to price through input costs. If consumers prefer buying less costly products from abroad, the relocation trend will quickly turn into a nearshoring or offshoring trend once again.

So, it's not the end of globalisation

Changes in supply chains are happening constantly. Although recent global events have spurred the desire for more self-sufficiency, and the trend toward 'friendshoring' and reconsidering business operations, we do not see much evidence of reshoring happening. So far, the trade war, Covid, and the war in Ukraine have diverted more than destroyed trade. We expect commodity flows to continue changing source, but that they will still be traded. There will also be some shifts from China to other Asian countries and more self-sufficiency build-ups in Europe and in the US for diversification and risk reasons, but this will mainly be done in strategic sectors.

The shifts currently happening in global trade are an ongoing investigation. We believe that it is a long-term process and that those changes will only show up in numbers at the earliest sometime next year. The shift towards more self-sufficiency, for example, is unlikely to show up in trade numbers anytime soon, as so far this has affected only some areas deemed critical, such as microchips or certain commodities. Of course, there could be a delayed effect on reshoring as it is hard to shift complete production facilities overnight. To keep track of the trade front, we will look at overall trade, intermediate trade in goods, and in particular regional trade flows. Intra-Asian trade, for example, should show higher growth rates in trade than overall trade.

Overall, conditions for international trade remain very tough and the low costs and perceived low risks (both political and logistical) which helped to support the development of global supply chains have become sources of uncertainty. However, looking at the full picture, the benefits for trade still hold and supply chains remain intact for now. It's about rerouting, diversification in suppliers and or regions, more stockpiling, and inventory building. It's not about the end of globalisation. Right now, it is a matter of planning further ahead than ever before, creating new opportunities for trade.

What else could manufacturers, shippers and logistics services providers do to manage supply chain risk and build resilience alongside diversification of sourcing?

- More frequent ordering in smaller batches.

- More buffer stocks (just in case inventory) and planning further ahead.
- Invest in own container equipment,.
- Use multiple modalities for flexibility – e.g. air cargo for time-sensitive shipments.
- Invest in better data/ICT to keep track of shipments.

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