
8 Global supply chains will not be the same in the post-COVID-19 world

Beata Javorcik

EBRD, University of Oxford and CEPR

For too long we have been taking globalisation for granted. Until recently, low tariffs and stable trading rules had been a key feature of our world. But the combination of trade-policy shocks and COVID-19 has created uncertainty about the future of free trade and sparked a rethinking of global value chains. Going forth, firms will need to diversify their supplier base and look at reshoring. At the same time, opportunities will arise for less popular investment destinations to enter or to intensify participation in global value chains.

For too long we have been taking globalisation for granted. Until recently, low tariffs and stable trading rules had been a key feature of our world. The WTO and preferential trade agreements eliminated uncertainty about trade policy, and the WTO's dispute settlement mechanism was a central pillar of the multilateral trading system. Contrary to popular fears, even the Global Crisis did not bring about a resurgence of protectionism and trade wars.

The stability of the trading rules encouraged producers to set up production networks spanning the globe, placing different stages of a manufacturing process in different countries, often far away from the consumers of the final products. The focus was on cost optimisation, ruthless cost-cutting, and just-in-time production. Holding sizeable inventories was perceived as wasteful. From time to time, global value chains were rattled by a shock, such as the tsunami and earthquake that hit Japan in March 2011 and whose impact forced Japanese corporations in the US to halt production as they were unable to obtain parts and components from the suppliers in Japan. However, these shocks were perceived as one-off events, temporary disturbances to an otherwise successful business model.

But the world has changed. The combination of trade-policy shocks and COVID-19 may have created a perfect storm. Each of the events by itself would not be enough to spark a rethinking of global value chains, but the two combined may just do so.

The trade war between the US and China and recent restrictions on exports of medical supplies and agricultural products have created uncertainty about the future of free trade. It is no longer inconceivable that globalisation will be rolled back with national security arguments used to justify protectionism. The 2018 tariffs on aluminium and steel introduced by the US based on national security exceptions to the WTO rules have already paved the way for future protectionism. Business can no longer take it for granted that current tariff commitments enshrined in the WTO rules will prevent sudden protectionist surges, particularly as the WTO dispute-settlement mechanism has stopped functioning.

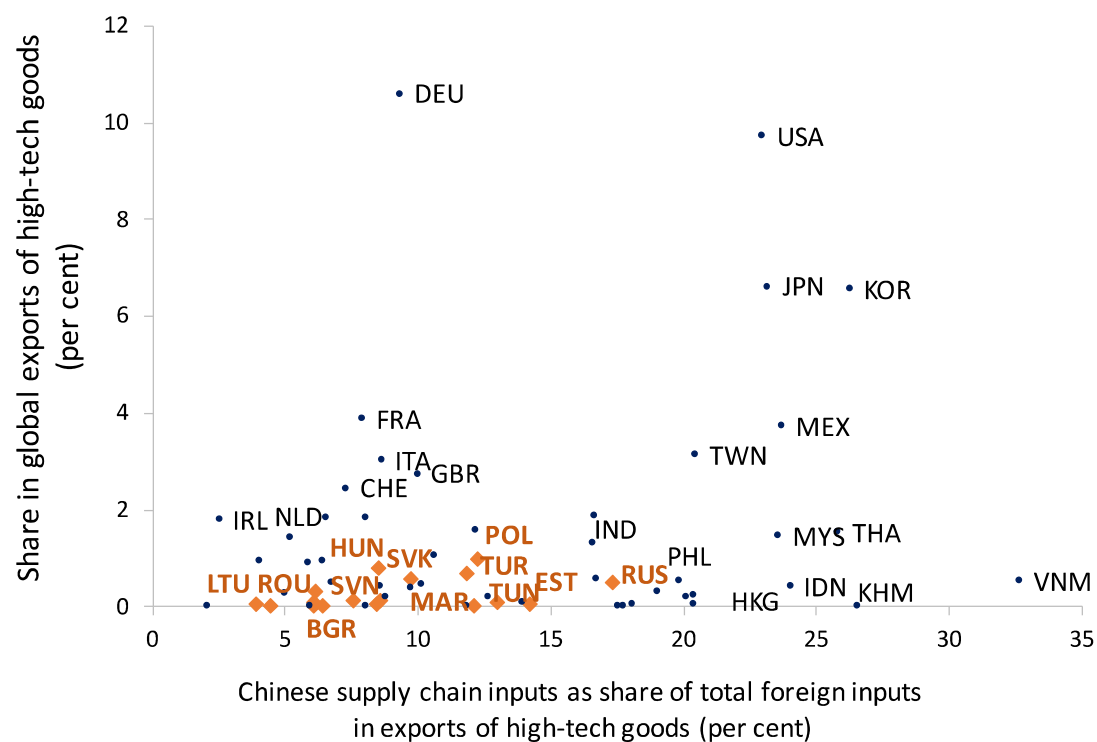
At the same time, COVID-19 has exposed vulnerabilities of the global supply chains to disruptions as well as what many may consider an excessive reliance on China for supplies.

The virus outbreak, which initially led to temporary closures of factories in the Chinese province of Hubei, caused disruptions in production on many continents. Hubei accounts for only 4.5% of Chinese GDP, but it is a high-tech manufacturing hub, home to local and foreign firms highly integrated into global supply chains in the automotive, electronic, and pharmaceutical industries.

As illustrated in Figure 1, firms in Asia and North America were particularly exposed to this disruption. About a quarter of intermediate inputs used in high-tech exports (defined as pharmaceuticals and chemical products, machinery, motor vehicles, and other transport equipment) in the US, Japan, Korea, and Mexico come from China. But even a car plant in Serbia had to stop production because its suppliers in China were unable to deliver parts.

Dependence on China can also be seen at the country level. Many countries are only now discovering how dependent they are on supplies coming from China (Figure 2). For example, almost three-quarters of blood thinners imported by Italy come from China. This is also true for 60% of antibiotic components imported by Japan and 40% imported by Germany, Italy, and France. This realisation has led to calls urging more self-reliance and reshoring.

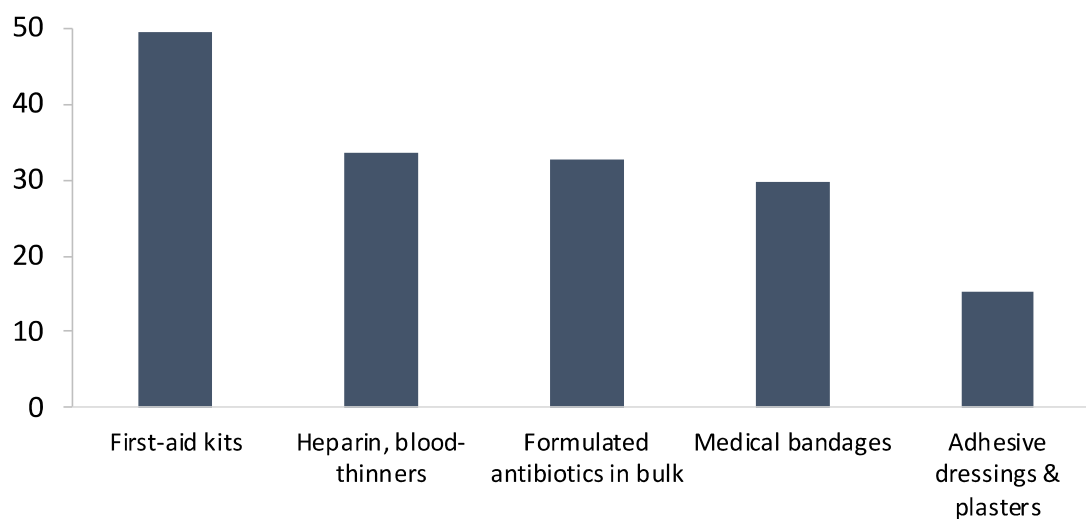
Figure 1 China's value-added as a share of total foreign value-added in exports, 2015 (%)



Notes: High-tech goods include pharmaceuticals and chemicals, computers, electronic and electrical equipment, machinery, motor vehicles, and other transport equipment.

Sources: EBRD (2020).

Figure 2 China's share in G7 total imports of selected medical supplies, 2018 (%)



Notes: Imports are for the following HS codes: 300650, 300190, 300320, 300590, 300570.

Sources: EBRD (2020).

The current events will force businesses to re-engineer their global value chains. These chains were designed to maximise efficiency and profits. And while just-in-time manufacturing may be the optimal way of producing complex products, the pandemic has exposed weaknesses inherent in a system that requires all of its parts to work like clockwork.

And more disruption may be under way. Scientists warn us that climate change will bring more extreme weather events and new outbreaks of infectious diseases. In the absence of decisive action on climate mitigation, shocks reverberating through the global economic system will become common.

Firms will be forced by their shareholders and rating agencies to think about the resilience of their global value chains. They will need to diversify their supplier base to protect against disruptions affecting a particular producer or a particular geographic location. There may be some reshoring, especially as automation has already reduced the importance of labour costs.

But this rethinking will also create opportunities for less popular investment destinations. Just to give an example, many countries in eastern Europe and eastern and southern Mediterranean have a comparative advantage in products exported by China (Figure 3), and eastern European countries are already exporting pharmaceutical products (Figure 4).

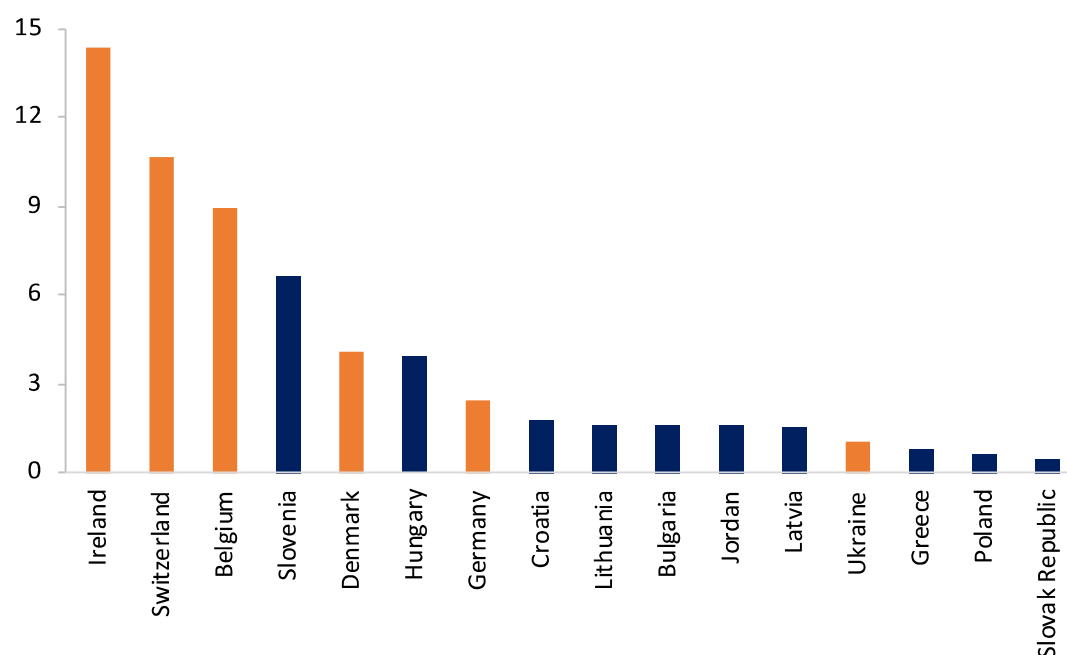
To seize this opportunity to enter or to intensify participation in global value chains, interested countries will need to step up their investment promotion efforts. They will need to inform potential investors about business opportunities on offer, showcase their commitment to maintaining a good business climate, and signal their welcoming attitude to foreign direct investment. The right strategy is not about fiscal incentives or other giveaways; it is about real commitment to fair treatment, stable and transparent rules, and investor-friendly attitude. Investment promotion is surprisingly cheap and effective (Harding and Javorcik 2011, 2013) but it will not work without the support of political leadership at the very top.

Figure 3 Which countries will take advantage of rethinking of global value chains?

Notes: The figures pertain to 4-digit HS codes in 2018. Bubble size indicates the absolute export volume in millions of US dollars. Restricted to lines with revealed comparative advantage ≥ 3 and export volume of more than \$500 million.

Source: EBRD (2020).

Figure 4 Pharmaceutical exports as a share of GDP, 2018 (%)



Notes: Exports are for all pharmaceutical 4-digit HS codes.

Sources: EBRD (2020).

References

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About the author

Beata Javorcik is Chief Economist at the European Bank for Reconstruction and Development, Professor of Economics at the University of Oxford and Programme Director of the International Trade and Regional Economics programme at CEPR. She specialises in international trade and economic development. Prior to coming to Oxford, she worked for eight years at the World Bank in Washington DC where she was involved in research activities, lending operations and provision of policy advice to developing countries in Central and Eastern Europe, Latin America and Asia.