Think:Act

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IDEAS FOR ACTION

THE CHANGING FACE OF GLOBALIZATION

Roland Berger

Globalization as we know it is reeling and may never fully recover to pre-pandemic levels, but companies and consumers, conditioned by the Amazon Prime effect, still want things faster. The push and pull of automation vs. labor costs, global logistics and the ecological footprint of shipping all point to increased regional trade taking an even larger share of merchandise trade and attracting more foreign direct investments, services and data flows. Regionalization, in short, has many of the prerequisites to become the next chapter of globalization.

BY ***Steffan Heuer***

Plants left idle, containers stacking up, empty warehouses or parts shortages: The Covid-19 pandemic has ravaged global economies and exposed the weak spots in what is generally considered a resounding success story of connecting more economies around the world in an intricate web of manufacturing and, in its wake, lifting millions of people out of poverty. Yet as global value chains (GVC) have been damaged or even severed, now is the time for companies to rethink the way they do business, where to make products and how to best source their various inputs.

Paying closer attention to the rising trends of regionalization, which have both been underway for a while now, can show companies the way forward to stay competitive and successful in this next phase of globalization. It will be a new era in which globalization is no longer primarily focused on offshoring production and moving components and goods around in millions of shipping containers. Instead, says Stefan Schaible, Global Managing Partner of Roland Berger, "the business world post-2020 comes down to making globalization resilient and sustainable."

From hyperglobalization to "slowbalization"

As the saying goes, you need to understand history to avoid repeating past mistakes. So how did globalization as we know it evolve? Most scholars agree that the rise of global trade and global value chains was an overall success story. Cycles of globalization and deglobalization, interrupted by two world wars and economic crises, fused the world's economies closer together over the course of the 19th and 20th centuries. Not only did merchandise trade rise across the board, having workers in less developed economies produce the goods and components that industrialized economies needed helped to alleviate poverty for hundreds of millions of people.

The 1990s and 2000s are generally considered the "golden age" of globalization, or "hyperglobalization" as some prefer to call it when taking a closer look at the frenzy of offshoring that occurred while companies were chasing lower labor costs and relying on ever-falling costs for shipping and communications.

Hidden beneath this success story – and therefore often overlooked – were warning signs that the well-oiled machinery of global value chains was overheating and becoming overstretched. It came to a grinding halt when the financial crisis of 2008 hit. The rising tide, economists pointed out, did not lift all boats and instead had brought some economies close to capsizing. Income distribution and real income trends paint a picture of growing inequality, with the poorest and the richest segments of the population around the world benefiting the most, while the middle class in major industrialized economies saw modest or even no increases at all. The result was economic disruption and growing anxiety among workers even in

wealthy countries as factories were shuttered and production moved from one country to another. It created a fertile breeding ground for today's populist and protectionist movements.

Fast forward to 2020, when global trade as a percentage of GDP has hit a wall and openness to trade seems to be in retreat across the board. Academics, managers and politicians are trying to make sense of what will come next: a recovery to return to the old globalization as we know it, or a new chapter of globalization that is fundamentally different and therefore requires a different set of rules, tools, business models and processes.

The Dutch writer and trend watcher Adjiedj Bakas put his finger on the emerging trend when he coined the term "slowbalization" in 2015, which was quickly picked up in economic circles and even earned an approving write-up in *The Economist.* Going more slowly after the Great Recession was driven by several factors.

For one, shipping costs had stopped falling, making it less attractive to transport goods and components halfway around the world, sometimes even back and forth, while margins in many industries were decreasing. Second, the advantage of comparatively cheap labor was fading, with automation as the great antidote to wage arbitrage. Robots, after all, cost the same everywhere. Third, the global economy was experiencing a shift away from just merchandise trade in atoms to dealing with bits as in cross-border digital services and leveraging data in all its guises. US-based economist Anil Gupta even goes so far as calling digital globalization the new phase whose growth and opportunities will eclipse the merchandise trade chapter.

The fourth driver of slowbalization, Schaible points out, is maturing markets around the world that are unfolding their own dynamic. "Former offshoring and manufacturing hotspots such as China have become more sophisticated and self-reliant, meaning they are now experts at producing advanced goods for local and regional markets." And finally, he adds, politics has thrown a wrench into hyperglobalization. From the US and the United Kingdom to China and India, blanket market liberalization has been rolled back.

***BREAKING THE CHAIN** The well-oiled machinery of globalization can no longer function on the same paths as it once did.*

Enter regionalization

There is, however, a new trend emerging amid all the sobering figures documenting global trade in decline. Backward participation in global value chains – or the extent to which a

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GLOBAL MANAGING PARTNER, ROLAND BERGER

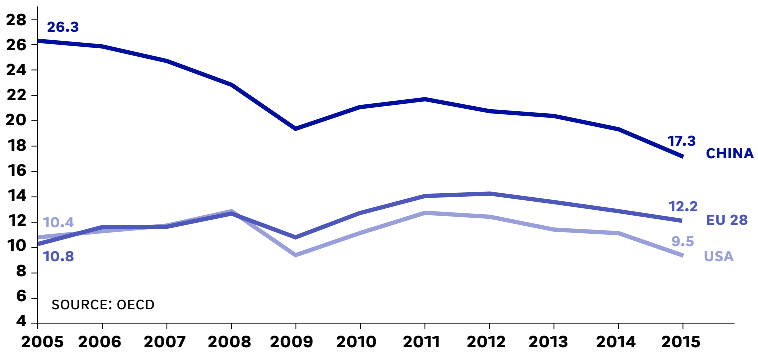
country's exports rely on intermediate products sourced from abroad – has continuously decreased in the three most important global markets since 2011. The TiVA database maintained by the Organisation for Economic Cooperation and Development (OECD) shows that nearshoring (from a region) and reshoring (to a company's home base) could well be the next chapter of globalization. If one looks at the foreign value-added share of gross exports for China, the 28-member countries of the EU as well as the US, the trend line for all four has gone down between 2011 and 2015 [see graph below]. Numbers for 2016 through 2018 are expected to be released later this year, but given the recent anti-trade sentiments among major economies this trend is assumed to continue.

In Europe, the data show growth in regionalization which is benefiting Eastern European economies. Companies in Germany and France have shifted some of their value-added exports to Eastern European countries, meaning they rely more on their Eastern neighbors to provide intermediate products. The share for Germany went up by more than half, from 1.6% in 2005 to 2.0% in 2011 and 2.3% in 2015, while the corresponding numbers in France rose from 0.6% in 2005 to 0.9% in 2015. Those numbers indicate that nearshoring within the region is gaining traction. Schaible explains: "We are seeing a continuous decrease of backward participation in the three biggest economic blocks in the world, so integration into global value chains is weakening. But that doesn't automatically answer the question as to what value chains of the future will look like." In the future, globalization might probably have different faces in different regions.

China, according to OECD data, presents a slightly different picture than Europe. Its backward participation has also decreased, but for a different reason. The country's economy has become increasingly focused on the domestic market to source intermediate products and for the consumption of finished products. So while China has massively increased its overall exports, it has at the same time raised the share of value added domestically, from 73.7% in 2005 to 82.7% in 2015.

The backward participation in global value chains is slightly decreasing in important countries and regions since 2011

Backward participation in GVCs: Foreign value-added share of gross exports, by origin country [2005-2015]



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The promise: making trade more sustainable and resilient

If regionalization is indeed here to stay and growing, and if protectionism is rearing its head in many locales, how can companies best adapt and compensate for the damage their global value chain might have suffered?

Should they step back from offshoring and instead consider nearshoring or outright production at home? "We don't consider nearshoring a silver bullet, but we do think that regionalization can significantly contribute to get growth back on track," says Schaible. "It will not replace globalization or spell the end of offshoring, but it is an important trend. Companies should get on board to make themselves – and global trade – more sustainable and resilient."

This assessment is shared by the most recent World Investment Report 2020 issued by the UN Conference on Trade and Development (UNCTAD). "Reshoring, diversification and regionalization will drive [the] restructuring of global value chains," UNCTAD concludes. "The decade to 2030 is likely to prove a decade of transformation for international production." The body's Director of Investment and Enterprise, James Zhan, elaborated on the challenges ahead when the report was released: "The changing context of international production demands a degree of rebalancing toward growth based on regional demand and on services."

That, in a nutshell, is what companies need to know to develop a playbook for the next chapter in globalization. Making goods closer to their final markets is a more sustainable mode of production and poses fewer risks to your supply chain as well as minimizing the potential disruption of the social systems in which your company operates. It also fits nicely with the declared goal of most countries and companies to transition to a more sustainable economy. Asian countries are no longer the factories for the world. Instead, they have developed vibrant internal markets and possess the knowledge to produce sophisticated goods for local and near-local markets.

Retooling the value chain can also help blunt the forces of populism and protectionism because even protectionist administrations like the Trump White House want free trade to continue uninterrupted within their region. A good case in point is the new United States-Mexico-Canada Agreement (USMCA) which replaced NAFTA in July. While global trade rules and enforcement bodies such as the WTO Appeals Court are

A BETTER WAY FROM A TO B
Keeping your focus local and shortening trade routes increases your resilience.

under attack or crumbling, regionalization presents a way out of this dilemma – assuming all stakeholders can come up with new rules that reflect the changes in global trade patterns.

Your corporate checklist

So much for the rearranged game board, but how does a company get ready to play in a more regionalized world? Schaible argues that plenty of enterprises are better prepared than they think. "Many companies already know how to source things regionally, they are equipped to handle this transition. First, they should do a sort of globalization check, meaning they should take a long and hard look at their current business model and supply chain. They ought to think in scenarios when it comes to destinations. How are we involved in different regions of the world? Then ask yourself what might happen? And are we as a company equipped to deal with it?"

In practice, that means drawing up a comprehensive list of multiple sourcing options and researching or exploring more sources for components and products that are closer to a company's various locations. You want to avoid being dependent on a single vendor who might be far away or at risk of being put under political pressure and/or trade restrictions. "Companies should know where there suppliers are, in which economic and political environment they operate and what small yet crucial component from one source can throw their whole GVC into disarray," says Schaible.

Companies should also experiment with new technologies and novel concepts such as Manufacturing as a Service. In the latter case, a platform can check various suppliers who might, for instance, be able to turn a digital CAD file into a product. And last but not least, companies ought to truly familiarize themselves with each of the markets in which they are operating in order to get a clear understanding of the respective legal frameworks and associated risks.

"The overarching thought guiding all of this should be the realization that your supply chain is part of a larger question," explains Schaible. "It goes to the heart of a company's business model. Can you simplify your business model?" Or plainly put: What will I be doing on my own and what should I do with partners? It might seem like a slow approach at first, but it promises to pay off as regions will shape the coming decade. ■

THE LOGIC OF LOCAL
Keeping production close to the end market is sustainable and offers minimal risk of disruption.

Checklist: get ready for a regionalized world

1 – Perform a transparent check of your supply chain: Do you know all of your tier-3 and tier-4 suppliers?

2 – Assign each part of the supply chain a risk factor: Looking at this, are you prepared?

3 – Rethink your entire business model and value proposition: What do you need to outsource?

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