Friend-Shoring Reconsidered

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Abstract:

In recent years, there has been a growing awareness of the differences in political systems among countries in the organization of global supply chains. The concept of "friend-shoring" was born out of this situation. Friend-shoring refers to the establishment of a production ecosystem among countries with similar political systems and values, or government initiatives to this end.

For example, the Trade and Technology Council (TTC) in Europe, the Americas Partnership for Economic Prosperity (APEP) in the Americas, and the Indo-Pacific Economic Framework (IPEF) in the Indo-Pacific region are examples of friend-shoring, especially in the United States. China, on the other hand, has also launched the "One Belt, One Road" initiative and is promoting extensive friend-shoring that links Eurasia to the African continent.

Friend-shoring has become a global trend, and this paper examines its impact on the global economy and policy issues from a political economy perspective.

Since the end of the Cold War, global value chains (GVC) have continued to expand and develop, transcending differences in political systems, under the international order led by the US and the world situation referred to as "political cold and economic heat".[1] China, in particular, has used its huge population to enter international markets and establish overwhelming competitiveness in labor-intensive industries. Companies from developed countries sought China's inexpensive labor force and promoted manufacturing offshoring (offshore outsourcing or foreign direct investment) to the country. Supply chains not only in East Asia, but also in other countries and regions, became concentrated in China, the "Factory of the World".

During the period of "political cold and economic heat" this fact was not a particular problem. However, the situation took a sudden turn. The global financial crisis triggered a period of low

[1] A situation in which the international economy evolves relatively free from political considerations.

growth, and emerging economies were caught up in technology. The balance of power between developed and developing countries was shaken, and tensions rose sharply, especially between the US and China. The Hu Jintao administration in China at the time saw the new situation brought about by the global financial crisis as an opportunity to shift international power, and took a hardline stance toward the outside world. This trend accelerated under President Xi Jinping, and China was now transformed from a good economic partner of the US into a major political and military threat in the Indo-Pacific region.

The *Chart* shows a bird's-eye view of changes in economic interdependence in the Indo-Pacific region from 1995 to 2020. It shows 15 countries and regions in the Indo-Pacific area on the vertical and horizontal axes, respectively. The contour lines are drawn along the strength of interdependence among industries, with the horizontal axis showing the strength of interdependence among countries and regions as suppliers of intermediate goods, and the vertical axis showing the strength of interdependence among users of intermediate goods.

Let us trace the changes in the contour lines over time. First, in 1995, inter-economic linkages were very weak and scattered. Only localized linkages can be observed around Japan and Singapore, but a production network covering the entire region has not yet emerged. Subsequently, remarkable linkage relationships began to spread throughout the region from around 2005. However, at this stage, they have not yet taken a definite form, but are merely developing in a disorderly manner like an amoeba. Then, by 2015, the linkages cover almost the entire region, and in particular, we can see a clear structuring into a production network with China as the hub. This trend does not abate in 2020, confirming the overwhelming presence of the Chinese economy in the Indo-Pacific region.

The era of "political cold and economic heat" will come to an end as China's external posture changes, its technological capabilities improve, and its military-civilian integration progresses. Today, politics and economics are so closely intertwined that it is no longer possible to consider one without the other.

The concept of friend-shoring was born out of this situation. It refers to the establishment of a production ecosystem among countries with similar political systems and values, and to government efforts toward this end. Until recently, multinational companies were motivated solely by the comparative advantage of each country's production factors, and "differences in political values" were not often considered in the organization of supply chains. Today, however, it is an important factor that weighs heavily on the international expansion of business.

The other approach that is often mentioned alongside friend-shoring is reshoring (returning to the home economy). The difference is whether the reallocation of overseas production bases and outsourcing is limited to a country's own territory (reshoring) or kept within a group of like-minded countries (friend-shoring), both of which have the security objective of avoiding economic coercion and theft of key advanced technologies by rival countries.

In the case of reshoring, however, protectionist motives often drive it. The downside of this is that, in the name of security, shifting the procurement of components to inefficient domestic industries can lead to higher production costs and seriously undermine the international competitiveness of the home country's firms. Furthermore, in terms of the risk that production activities will be concentrated domestically, reshoring is generally not supported from economists' viewpoints.

In contrast, friend-shoring, in addition to its aspect of risk diversification in preparation for unforeseen situations, also has important functions from a strategic perspective. For example, a basic concept in traditional deterrence theory is "deterrence by denial". This is the concept of deterring hostile actions by an adversary by preparing a mechanism to limit the effectiveness of their actions and by making them known to the adversary in advance. In the military field, anti-aircraft missile defense exemplifies this, but friend-shoring can function as an economic security version of this concept.

The Indo-Pacific Economic Framework (IPEF) Supply Chain Agreement, the EU Economic Security Strategy's Single Market Emergency Instrument, and the 2023 Japan-US Critical Minerals Supply Chain Enhancement Agreement all provide for intra-group flexibility when member countries face supply bottlenecks. From the perspective of a rival country, this lowers the expected impact of economic coercive actions, such as export restrictions, and reduces the willingness to exercise them. Above all, the fact that these mechanisms are articulated in friend-shoring, and the willingness of like-minded countries to engage in a coordinated manner, can enhance deterrence.

As the political factors in the international organization of supply chains expanded, Western countries began to build friend-shoring institutions. With the Trade and Technology Council (TTC) in Europe, the Americas Partnership for Economic Prosperity (APEP) in the Americas, and the Indo-Pacific region's IPEF, the US-centric friend-shoring strategy is expanding its reach around the world. China, on the other hand, has also launched the "One Belt, One Road" initiative and is pushing forward with a vast friend-shoring initiative linking Eurasia to the African continent.

Although friend-shoring has become a global trend, it is not without its problems. First, there is always the question of whether government intervention is necessary in friend-shoring. In the past, have governments ever provided subsidies or other support for withdrawal from projects that involve geopolitical risks, such as oil field development in Middle Eastern countries, even if the local situation deteriorates and the company decides to withdraw from the project? The company concerned should have done so at its own expense, based on its own risk assessment and profit-and-loss evaluation.

Government intervention such as subsidies requires public funds, which, of course, are generated from taxes. Therefore, the implementation of such intervention requires a certain public nature, and it will be necessary to carefully examine how "public" the friend-shoring policy is.

What we would like to consider is the possibility of friend-shoring that does not involve the input of public funds such as subsidies.

According to traditional international trade theory, it is the comparative advantage of each country that determines the shape of its supply chain, and the possession of production factors such as labor, capital (including human capital), and land (natural resources) that determine that comparative advantage. Today, however, amid concerns about government intervention in business for security reasons and its political and diplomatic use, global companies have come to consider the robustness of institutions in the potential partner country and their compatibility with the business environment in the home country as important reference points for risk assessment when expanding overseas. In other words, in addition to the traditional comparative advantages of "labor, capital, and land", the "institutions" and even "political values" of each country have been added as factors that determine a company's international expansion.

For example, a product may be described as labor- or capital-intensive in terms of its attributes, but a product that uses sensitive or dual-use technologies may be described as "economic security" intensive. Then, just as countries with abundant labor have a comparative advantage in labor-intensive industries, the quality of economic security-related institutions will determine a country's international competitiveness in the production of economic security-intensive products.

Therefore, what governments should do with regard to friend-shoring is not to provide financial incentives such as subsidies, but to enhance the competitive advantage of economic security-intensive industries through the development of legal systems. Countries that have established domestic legal systems related to economic security will be more likely to attract supply chains of sensitive technologies and critical strategic goods. If this is done in a coordinated manner among like-minded countries, it should be possible to achieve goals comparable to those of conventional subsidy-dependent friend-shoring.

On the other hand, it is also necessary to consider the long-term, big-picture implications of friend-shoring. Consider, for example, the IPEF, which the administration of President Joe Biden itself has publicly stated is one of the tools of its friend-shoring policy in its report to the President's Executive Order "On America's Supply Chain" (The White House, 2022).[2] Along with the IPEF, the administration has also launched the BuildBackBetterWorld (B3W) initiative to promote infrastructure development and technology cooperation in the Indo-Pacific region[3].

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[2] The White House (2022), *Indo-Pacific Strategy of the United States*.

[3] Reorganized into the Partnership for Global Infrastructure and Investment (PGII) at the G7 Elmau Summit in 2022.

The IPEF and B3W are positioned as two wheels of the US "Indo-Pacific Strategy" and it is highly likely that they are viewed as a single negotiating package from the perspective of developing countries. In other words, in return for complying with high-standard international rules such as those set by the IPEF, developing countries can choose to receive infrastructure support and technical cooperation from the B3W.

This is precisely what Richard Baldwin predicted is now emerging in the Indo-Pacific region. While 20th century international governance, centered on trade liberalization, was based on the relatively equal relationship of mutual market opening between the parties concerned, 21st century governance assumes the existence of an overwhelming power differential between the rule makers (i.e., developed countries) and the followers (i.e., developing countries). This power differential is based on capital, technology, and economic power. This difference in power is the difference in capital and technological capabilities, and developed countries force developing countries to reform their institutions and conform to common rules in exchange for the "foreign direct investment = capital and technology transfer" card.

Of course, for developing country governments, this may be a painful process of domestic institutional reform toward the internationalization of rules. However, the supply-side capacity-building support in the form of infrastructure investment and technical cooperation by the B3W should be attractive enough. As a result, it was initially thought that the ASEAN countries would pass a cautious stance toward the US-led framework of the IPEF out of consideration for China, but in the end, seven countries announced their participation in the negotiations.

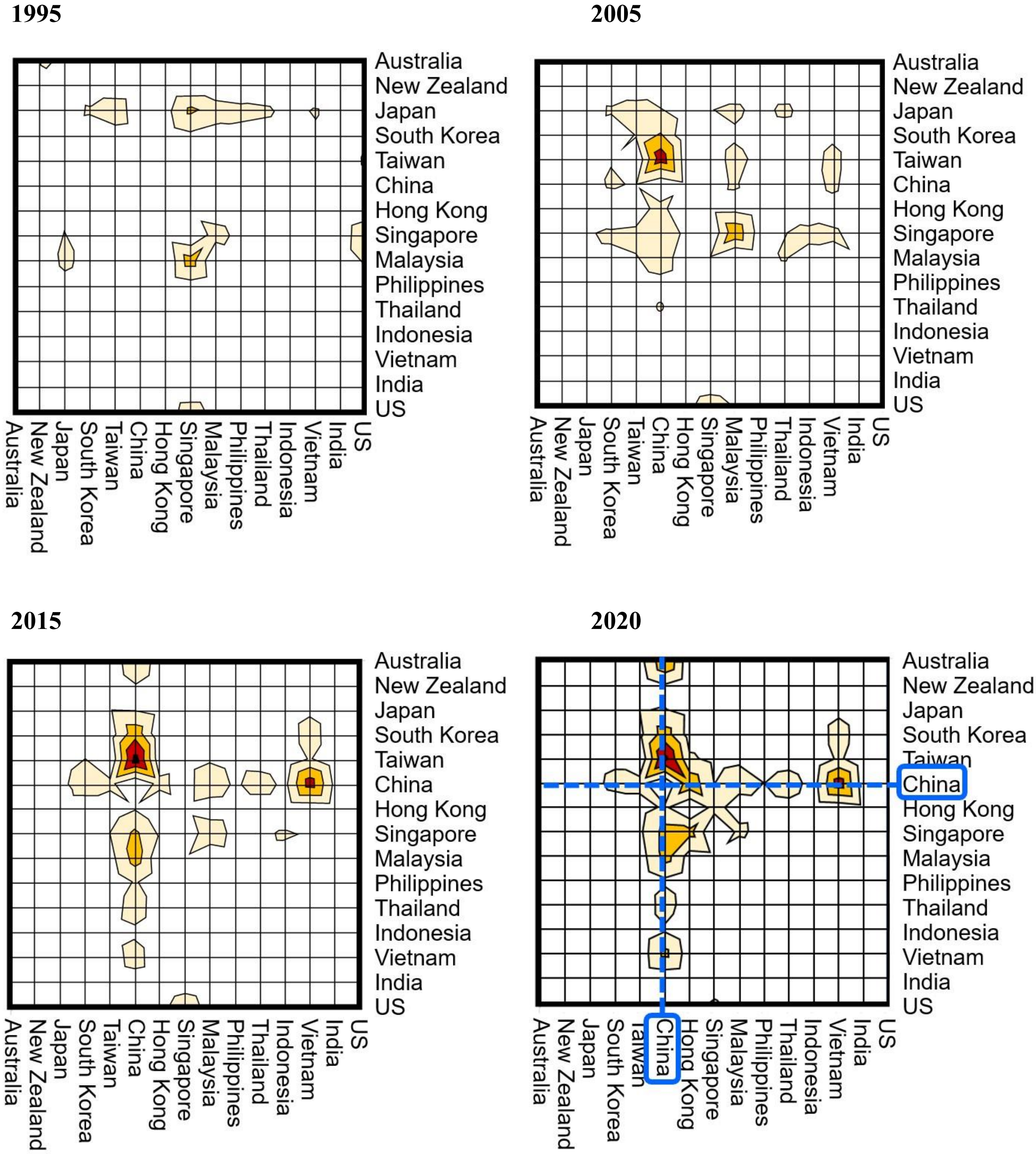
The US "Indo-Pacific Strategy" is paired with China's "One Belt, One Road" initiative. If the competition for "21st century-style international governance" involving developing countries continues to intensify between the US and China, there is a danger that economic decoupling will become entrenched as a regime due to the fragmentation of international rules.

It is also extremely difficult to reintegrate supply chains once they have developed along different paths. In particular, as society undergoes digital transformation (GX), the decoupling of information and communication technologies will be a major loss for the global economy. In addition, industries that are considered key strategic sectors for security, such as food and healthcare, are directly linked to global issues of poverty and energy-related industries to environmental issues. If decoupling proceeds in these areas where international cooperation is most needed, the trend toward the Sustainable Development Goals (SDG), which are attracting global attention, will be greatly slowed down.

Furthermore, if opportunities for communication and information sharing among companies through international supply chains are undermined in the future, dialogue and trust between countries will eventually be severed, and the international situation may become increasingly unstable.

How can we reconcile economic and security concerns? We are now faced with an unprecedented challenge.

CHART: Changes in Economic Interdependence in the Indo-Pacific Region: 1995-2020



Source: Compiled by the author
Note: This figure shows only international linkages; domestic industry linkages (diagonal lines) are excluded from the view.

Satoshi Inomata is chief senior researcher at the Institute of Developing Economies, Japan External Trade Organization. His recent research includes in-depth studies of global value chains using network theories and input-output techniques. He has been awarded three prestigious academic prizes in Japan for his new book *Geopolitics of Global Value Chains* (2023) and for the previous book *Global Value Chains* (2019), both from the Nikkei Publishing, Japan.