Global Supply Chain Restructuring: Current Trends and Impacts

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Abstract: *Recently, the Sixth Bund Summit was co-hosted by the China Finance 40 Forum and the China Center for International Economic Exchanges. A closed-door seminar was held during the summit on the topic of Fragmentation of Global Trade and Finance: Decoupling and Rebuilding Relations.*

The seminar concluded that, in recent years, many countries have sought to reduce their dependence on China, but China's production capacity remains irreplaceable in the short term. At the same time, although global economic integration remains highly advanced, it has become more unbalanced: trade surpluses are concentrated in China, while deficits are concentrated in the U.S., exacerbating global imbalances. Much of the global flow of investment and goods is driven by tax avoidance rather than production needs.

European countries, represented by Germany, has long relied on global supply chains for their economy, the United States for defense and Russia for energy. Currently, it faces significant challenges in transitioning, leading to a rise in protectionist tendencies and a shift toward political extremism in Germany. International experts pointed out that as China's trade surplus with Europe increases, Europe will feel a profound sense of challenge. China should mitigate the risk of a rising "China shock" narrative in Europe.

Moreover, the restructuring of supply chains could lead to divergent global inflation trends. With the U.S. and Europe facing high inflationary pressures, while Eastern countries may experience low inflation, this divergence in global monetary policies is expected to widen. In response to inflationary pressures, the experts at the meeting believed that central banks in the U.S. and Europe should maintain their 2% inflation targets.

I. Despite of the Rise of Global Trade Protectionism, China's Production Capacity is Irreplaceable in the Short Term

Benjamin Hung, president of Standard Chartered Bank's International Business, believed that **in recent years, global supply chains have undergone significant adjustments, primarily due to the rise of trade protectionism driven by geopolitical tensions.** He explained that for the past 20-plus years, global supply chains were centered around China as the world's factory, directly supplying goods to Europe and the U.S. However, in recent years, more Chinese goods must now pass through the "Global South" (developing countries) before reaching Europe and the U.S. The share of "South-South trade" (trade between developing countries) in global trade has rapidly risen from 5% thirty years ago to around 30% today. **He also thought that future globalization will be characterized more by increased intra-regional trade rather than global trade.**

Many countries are currently looking to restructure their supply chains through the "China+1" strategy, aiming to reduce dependence on Chinese manufacturing. However, it is difficult to find a substitute for China's production capacity in the short term. Hung pointed out that China has built a comprehensive industrial ecosystem through high-quality labor, technology, and infrastructure, making it hard for other countries to replicate. While many states are striving to use the "China+1" approach to reconstruct supply chains, this effort faces significant challenges. For example, China's production capacity in industries such as textiles, home appliances, and smartphones ranks first in the world, with Chinese capacity being 7-10 times that of the second-largest producer in each of these sectors. Reducing dependence on Chinese production will take a long time.

II. While Global Economic Integration Remains High, Imbalances Have Increased Significantly

Brad W. Setser, Senior Fellow at the Council on Foreign Relations, argued that while the rise of trade protectionism and other phenomena suggest a trend toward "de-globalization", global economic integration remains very high. This can be seen in two main aspects:

First, globalization driven by tax avoidance needs remains high and has even strengthened. Setser noted that the U.S. now imports twice as many pharmaceuticals from low-tax regions as it did in 2017, and the offshore profits of American companies in these low-tax regions have not significantly decreased.

Second, China's goods trade surplus has been expanding in recent years, indicating that China's economy is becoming increasingly reliant on exports, and global dependence on Chinese production remains high. Setser believed that due to relatively weak domestic demand in recent years, China has leaned more toward increasing exports. After transiting through other developing countries, the U.S. and Europe still remain the primary markets for Chinese exports. The proportion of Chinese exports to GDP and China's manufacturing surplus to global GDP have both risen to historic highs, illustrating that China is becoming more dependent on exports, while the world continues to rely heavily on Chinese production. Setser further pointed out that the direct investment data between China and the U.S. may not be as important as imagined. This is because many U.S. companies invest in China through third-party companies, meaning that without substantial direct investment, actual trade between China and the U.S. can still remain robust.

However, Setser believed that the current state of global integration is unhealthy, with imbalances being too pronounced. On the one hand, a significant portion of the global flow of investment and goods is driven by tax avoidance rather than production needs. On the other hand, while China achieves an extremely high goods trade surplus, the U.S. faces a massive trade deficit, with the absolute size of the U.S. deficit nearing the scale of China's surplus. This indicates a severe imbalance in the global economy. He argued that efforts should be made to address tax avoidance issues and balance the relationships between surplus and deficit countries in order to promote a healthier form of economic globalization.

III. In the Current Situation, European Economies Such as Germany Face Severe Transformation Difficulties

Axel A. Weber, president of the Center for Financial Studies at Goethe University Frankfurt and former president of the Deutsche Bundesbank, pointed out that Germany has long depended on global supply chains for their economy, the United States for defense and Russia for energy. Against the backdrop of geopolitical tensions and supply chain restructuring, Germany faces high transformation costs and significant economic growth pressure, with other European countries facing similar challenges.

First, German manufacturing has previously over-optimized its supply chains. While extensive outsourcing of intermediate production helped German manufacturing achieve stable growth, external shocks such as the pandemic have made it difficult for domestic manufacturing to handle the series of problems arising from supply chain disruptions.

Second, Germany (and most European countries) relies on the U.S. for defense, with relatively low defense spending. However, the Russia-Ukraine conflict has placed Germany at the forefront of potential conflicts in Europe, increasing defense demands. Weber noted that Germany has long believed that conventional wars, other than nuclear conflicts, were highly unlikely in Europe, leading to less focus on updating defense and military equipment. In the context of geopolitical tensions, if Germany were to meet Trump's proposed target of increasing defense spending to over 2% of GDP, it would face substantial costs.

Third, Germany has long relied on inexpensive energy from Russia. Following the Russia-Ukraine conflict, Germany must establish its own energy system, which also requires long-term, high-level investment.

Fourth, existing mature companies in Germany lack innovation drive. Weber believes that many mature European companies have increasingly focused on process management during their development, becoming disconnected from technological research and development. Senior management in these companies has lost knowledge of real-world conditions, and technological innovation is neglected internally. The management is highly risk-averse, which stifles technological advancement.

Weber thought that for the next decade or longer, European economies represented by Germany will be in a high-cost transformation period, which will result in three main consequences:

The first is that statesmen are likely to propose industry protection policies such as increasing tariffs to support the development of domestic industries and enhance supply chain resilience. At the same time, domestic German companies will be the main opponents of such tariff policies, as they understand that if Germany raises import tariffs, the countries affected will retaliate by imposing higher tariffs on German exports.

The second is that to maintain profitability, German companies may shut down high-cost domestic factories. For example, Volkswagen is planning to close its German factories due to the high labor costs in Germany. This is likely to trigger considerable opposition and social problems.

The third is that German politics is becoming increasingly polarized and extreme. Weber believed that Germany is now witnessing the coexistence of far-right and far-left parties, with centrist forces growing weaker. In the past, forming a government required a coalition of two parties, then three, and future elections may necessitate a coalition of four parties. This means that all major parties will participate in forming the government. Although the extreme parties may not hold power, they can play a more significant role as opposition parties in the political landscape.

IV. China Should Be Aware of the Impact of High Trade Surpluses on European Political Tendencies

Brad Setser pointed out that the trade attitudes and policies of economies like Europe toward China largely depend on whether China is primarily a demand-side or supply-side player. He noted that China has increasingly reduced its imports of products from other countries, weakening its role as a demand-side market for others. When China joined the World Trade Organization (WTO), the proportion of manufacturing imports relative to GDP was about 15%, but currently, if processing trade is excluded, this proportion may drop to around 4%. Meanwhile, China's exports are increasing, strengthening its role as a supplier for other countries.

Setser believed that as China imports relatively less from Europe, exports more and surpluses with Europe, it could influence European politics and create a "China shock" effect similar to what has been observed in the U.S. If China's domestic economic environment continues to position China only as a supply source for Europe, Europe will face significant losses, leading to profound challenges for the continent. This would be detrimental to China's external environment, and Setser suggested that China should consider how to adjust its policies to mitigate this risk.

V. While Supply Chain Restructuring Increases Inflation Pressure, Central Banks Should Stick to Their Inflation Targets

Benjamin Hung believed that supply chain restructuring will lead to structural, persistent inflation. At the same time, the global inflation landscape will become more differentiated, with Western countries such as the U.S. and Europe potentially facing high inflation, while Eastern countries may experience low inflation. As the U.S. and Europe focus on enhancing supply chain resilience, pursuing diversified strategies, and reducing dependence on China, inflation may remain elevated. Due to the divergence in inflation levels between the East and West, global monetary policy differences will also widen, leading to greater volatility in global monetary markets and economies.

However, in the face of inflation pressure from supply chain restructuring, experts attending the meeting believed that central banks should not change their existing inflation targets. Weber pointed out that macroeconomic policy cannot precisely adjust economic performance to a specific degree, but central bank policies must maintain a clear target. The 2% inflation target is a global standard established after 30 years of rigorous trials by central banks and should be upheld.

Jacob A. Frenkel, former governor of the Bank of Israel and former chairman of JPMorganChase International, also believed that central banks should not change their inflation targets, especially when the targets have not yet been met. Changing the targets would entirely undermine the credibility of central banks, and most countries that have adopted a 2% inflation target have achieved relatively good results. He also noted that monetary policy should enhance its forward-looking nature and avoid over-reliance on past data for decision-making. He criticized the Federal Reserve's monetary policy over the past decade for lacking sufficient foresight, partly because its decisions were overly dependent on historical data, leading to policy delays. Central banks should improve their forecasting capabilities, adjust policies based on expected changes, and enhance the forward-looking nature of monetary policy.