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Article

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Intereconomics

Suggested Citation: Bartholomae, Florian W.; Nam, Chang-woon (2023) : A Critical Discussion on the Reasons and Impacts of International Decoupling, Intereconomics, ISSN 1613-964X, Sciendo, Warsaw, Vol. 58, Iss. 2, pp. 92-95,
<https://doi.org/10.2478/ie-2023-0019>

This Version is available at:

<https://hdl.handle.net/10419/275700>

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Florian Bartholomae and Chang Woon Nam

A Critical Discussion on the Reasons and Impacts of International Decoupling

In the current economic policy debate, there are often calls to reverse advanced developments in globalisation and the international division of labour. Reasons such as greater business resilience, political independence and, from a climate perspective, less harmful production argue for not abolishing trade, but at least bundling a larger part of the value chain locally. However, such considerations are de facto made from the perspective of a highly developed and globally networked industrialised country. In contrast, this paper argues that trade activities can never be considered from the perspective of only one partner, but must always take into account the needs of all stakeholders, which in turn depend on the respective level of development.

In the current (economic) policy debate, the idea of reversing advanced developments in globalisation and the international division of labour is often voiced or even called for. Several reasons are cited for this, some of which are linked to certain views and socio-political goals.

Firstly, the pandemic control measures still in place, particularly in China, sometimes lead to considerable disruptions in supply chains, especially for intermediate products. This delays final production and leads to cost increases that fuel inflation. Therefore, it seems imperative to carry out important parts of value creation locally again to increase the resilience of production processes.

Secondly, the aggressive Russian invasion of Ukraine raises the question of whether, or at what intensity, trade should be conducted with autocratic countries. The example of China shows that the desired “change through trade” unfortunately often fails to materialise and, on the contrary, can even lead to a dangerous dependence on political arbitrariness.

Thirdly, the globally dispersed production steps and the associated transport lead to discussions, especially against

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Open Access funding provided by ZBW – Leibniz Information Centre for Economics.

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the background of environmental and climate change, about why products that can also be produced locally are imported from regions that are sometimes far away.

Thus, higher (business) resilience, (political) independence as well as less (environmentally) harmful production are an argument for not abolishing trade but rather bundling a larger part of the value chain locally. As in many economic crises, there is thus a call to buy/make locally.

Reshoring to increase resilience

Reshoring is the term used to describe the shifting back of the value chain at the corporate level, whereby companies return those production steps to their home country that were relocated in the course of international offshoring or outsourcing. Not quite as extreme are considerations of nearshoring, according to which the value added should at least partially be outsourced only to near or neighbouring countries (for example, from Germany to Poland). As Pegoraro et al. (2021) summarise, there are several advantages for companies through reshoring. Firstly, local production eliminates large transportation and trade costs, and local proximity enables a faster and more flexible response to unexpected problems. At the same time, however, production costs will not rise too significantly, as unit labour costs in many emerging markets have also increased in recent years. In addition, there are often problems with the (lack of) protection of intellectual property rights in emerging markets, so further costs can be saved. If more goods and value added are produced locally, regional clusters can be formed, which strengthen the local innovation power and thus also the local competitiveness (for example by realising economies of scale). In addition, reshoring can be advantageous from a risk perspective by countering protectionist tendencies in the economic policy of the home country (e.g. Brexit).

Despite all these benefits that are certainly true for some companies, it should not be forgotten that the international division of labour offers considerable efficiency advantages from an overall economic perspective and enables a better allocation of international resources – it is not for nothing that this strategy has been pursued very successfully by many companies to date. As with other measures, the question arises as to which goal is to be targeted and how this can be achieved in the most efficient manner. The creation of a functioning and resilient value chain is a legitimate goal, but the question is whether reshoring is really the best possible choice.

The vulnerability of value chains is also due to the fact that there are often only one or a few suppliers that, from an economic point of view, allow for maximum efficiency when economies of scale are realised, but can lead to significant transaction costs in an imperfect world. In particular, as can be seen in the case of the dependence on Russian gas, there is a risk of hold-up, i.e. the trading partner can exploit the dependence by dictating higher prices or worsening contract terms. There are, however, various possible solutions to this problem, such as second sourcing, i.e. the purchase of important goods from more than one partner (Choi and Davidson, 2004; Sandkamp, 2022). In this way, dependency is significantly reduced and the value chain is made more resilient.

Trade with selected partners

The choice of partner is directly related to the question of with whom trade can or should be conducted. In this context, the term “friend-shoring” is sometimes used, according to which value creation should take place in friendly economies that are characterised by the fact that they share the same values with the home country.

With regard to general trade, Menkhoff (2022) examines how many countries could be considered as trade partners for Germany if different standards were applied to the democratic conditions in the various countries. He uses the World Bank’s Voice and Accountability index as a democracy index to determine which countries have at least the same level of democracy as Germany or the least democratic EU country. Depending on the scenario, significant parts of the world are excluded. In the extreme case of the “German” standard, Germany would no longer trade with 98% of the world’s population since the majority of countries have a different understanding of democracy. To make matters worse, many resource-rich countries in particular fall into the category of autocracies, and that would significantly affect the German economy, which is short of natural resources. Menkhoff (2022) concludes that even if trade has not led to a significant improvement of democratic conditions in the past, not

trading would not necessarily have this educational effect. The question is therefore not whether trade should be conducted with undemocratic countries, but how the contradiction between aspiration and reality is to be judged (politically). What are the limits, for example in dealing with human rights, that represent the absolute minimum standard and when must social as well as cultural differences be taken into account? In addition, setting overly stringent standards can markedly reduce the number of partners, thereby jeopardising the resilience of the value chain (Sandkamp, 2022).

Reduction of environmental degradation and reduction of CO₂

Trade is also often associated with environmental degradation, as many environmental resources in less developed countries are “unregulated commons” characterised by a lack of property rights (Chichilnisky, 1994). One example is rainforests that are used for timber extraction or destroyed to make way for the production and export of crops such as coffee, sugar and palm oil. Problems in enforcing property rights result in a lack of economic incentive for sustainable management, leading to overexploitation of these resources. Trade further exacerbates this problem: factors of production appear “cheaper” in developing countries than in industrialised countries because they seem to be more abundant. This “comparative advantage” leads to the export of environmentally intensive goods. This is particularly problematic because industrialised countries actually have more efficient, i.e. resource-saving, technologies. In addition, the international transport of goods causes considerable CO₂ emissions.

The renunciation of trade with developing countries can, with corresponding market power, have negative effects on their economic development and increase poverty there; if trade was hardly significant, it has no effect at all on these countries and thus on environmental degradation. One possible solution, as with environment-related problems in general, would be an international approach. On the one hand, the institutions in developing countries must be improved so that property rights in particular are created and enforced. Chichilnisky (1994) refers to the duality of overexploitation and underpricing of resources – a fairer pricing would also lead to a reduction in poverty. In addition, CO₂ emissions must also be priced in transport. This would reveal the true costs at all levels, and trade would adjust accordingly. Some countries would then stop producing some goods because the true costs are too high, while they could deploy the freed-up resources in sectors where their real advantage lies. On the other hand, some goods would no longer be traded, but instead produced locally, since the higher transport costs do not justify production in more distant regions. In general, however, the benefits of trade far outweigh the environmental costs (Shapiro, 2016).

Level of industrial development and reshoring

The considerations put forward so far argue *de facto* from the perspective of a highly developed and globally interconnected industrialised country. However, trade activities can never be viewed from the perspective of only one partner, rather they must always take into account the needs of all parties involved, which in turn depend on the individual level of development (Rodrik, 2013; Panagariya, 2013).

One development approach practiced primarily in Asia is the “flying geese model” (Nam et al., 2017). In the convergence process practiced, imports are first substituted until domestic production has increased relative to domestic demand reaching such an extent that the country itself becomes an exporter (Lim, 2014). Thereafter, this “open” developing country continues to grow and industrially upgrade by increasing its capital stock and taking advantage of the learning opportunities that arise from that country’s economic relationships with the developed world.

If this stage-of-development model is consistently implemented, trade and foreign direct investment result in the relocation of industries from developed to developing countries due to the shift in competitive advantages and the emergence of comparative cost advantages (Nam, 2006). Thus, changes in a country’s trade structure are closely related to its industrial structure (see also Rivera-Batiz and Romer, 1991a, 1991b; Lloyd and Toguchi, 1996). Following this logic, as a country grows, its industrial structure gradually moves from the “natural resources and labour-dominated phase” to the “capital and imported technology-dominated phase” and the “R&D and innovation-dominated phase”, with the country taking on new competitive roles in the global economy and leaving less sophisticated activities to lower-tier economies (Balassa, 1965; Grossman and Helpman, 1991; Kasahara, 2004).

One example of this development process is China. As Blomqvist (1995) and Grow (1995) find, large-scale foreign direct investment flows associated with foreign technology transfers changed China’s specialisation patterns from labour-intensive to capital-intensive products more rapidly at an earlier stage of development (between 1985 and 1995) than was the case in the newly industrialised countries such as South Korea or Taiwan in the 1970s. This has enabled Chinese manufacturers to produce some high-tech products and capital goods as well as labour-intensive products simultaneously. Moreover, thanks to the rapidly increasing receptiveness of companies to new ideas and modern technologies (which also have better R&D infrastructure and human capital), the time needed for developing countries to imitate innovations has shortened significantly. (UNCTAD, 1996).

However, such a catch-up process can also fail, as the negative example of India shows. In 2014, Prime Minister Narendra Modi launched the “Make in India” industrial policy reform initiative to promote the local and national production of multinational and domestic companies in the manufacturing sector. The starting point was a low share of manufacturing in total value added and a shrinking share of exports (Singh and Ranjan, 2015). A comprehensive promotion along the value chain was pursued, from securing basic production factors (such as energy, minerals and water) to increasing companies’ R&D and innovation activities, which required very heterogeneous deregulation and support programmes. Ambitious quantitative targets were set to measure success, but these have not been met (see Nam, 2022). Babu (2020) attributes this to a huge overestimation by the government of the feasibility of implementation as well as the lack of an industrial policy focus. In addition, the initiative was seen as a policy that lacked an understanding of the comparative advantages of the domestic economy.

The lack of focus is due in particular to the fact that India’s economy is very diverse and includes labour-intensive sectors (food, textiles), resource-based industries and high-tech sectors. In addition, the different levels of development in the various sectors mean that a one-size-fits-all policy is hardly feasible. Moreover, by promoting labour-intensive industries, India wanted to create jobs for the less qualified to combat poverty. However, this clashes with long-term industrial growth and structural change, as redistributive motives lead to conflicting goals with improving the country’s overall productivity and competitiveness.

In the global market, India faces intense competition from China as well as other fast-growing Asian countries such as Vietnam and Indonesia. As India has the sixth largest private consumption in the world and is expected to rise to third place by 2030 (World Economic Forum, 2019), Rajan (2015) suggests the introduction of a kind of “Make for India” programme to achieve import substitution.

For India, Nam (2022) offers five basic recommendations: (1) systematic policy specification based on a better understanding of the economic structure (and situation) under global challenges, including the comparative advantages of the country’s major products and the strengths and weaknesses of its competitors in the global market; (2) the importance of rapid structural change in manufacturing for the country’s output, employment and productivity growth; (3) thorough assessment of the need for and scope of redistributive growth policies; (4) the development of interdependence between high-tech industries and modern services and the role of IT in this context; and (5) the creation of a national innovation system (well equipped with a highly skilled workforce) between modern industries and busi-

ness services and research institutions that better enable not only R&D collaboration, knowledge dissemination and application, but also the flexible exchange of skilled labour.

Policy conclusion

In an adapted form, the lessons from the “Make in India” campaign can also be applied to similarly designed programmes in other regions, especially if either the entire economy or at least large parts of the industries would have to be restructured to achieve real resilience of the value chains or a reduction in emissions associated with trade. However, the goals pursued by this industrial policy can be achieved even without significant restrictions on trade or the complete restructuring of the economy that would then be required.

Moreover, unlike India, many developed regions, such as Europe, or Germany in particular, are not in the comfortable position of having an enormous labour force potential at their disposal and would therefore have to proceed in a much more targeted manner or accept that other sectors will suffer considerably. Demographic change in particular will lead to a great need for health care and nursing personnel, but these qualified employees cannot be used at the same time for the production of industrial intermediate products. In addition, as the example of India shows, it is difficult to achieve different goals at the same time, such as more resilient value chains and environmental protection. More local production requires more energy, which, given existing shortages, can only exacerbate current problems.

Another issue concerns the global impact of increased local production in the developed world. This counteracts the catching-up process of developing countries, as it results in fewer sales markets for their exports gained through import substitution, further depriving them of the opportunity to continue to develop these industries and make progress. As a result, global poverty could rise, creating social tensions that, together with the regional upheavals already looming as a result of the climate crisis, contribute to a potentially dangerous situation.

One possibility for developed countries like EU member states would be to win India as a partner and to support this country in its efforts to become successful. India will soon be the largest country in the world (measured by population size), so the Western “flight” and search for “value partners” should not exclude this country. From both an economic and political perspective, a bloc formation such as developed countries vs developing countries would be an untenable aberration (Zissimos, 2022).

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