DISCUSSION PAPER

Supply Chain Reorientation: Prospects and Lessons

Şeymanur Yönt

TRT WORLD
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WRITTEN BY

Şeymanur Yönt

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ULUS, BEŞİKTAŞ

İSTANBUL / TÜRKİYE

TRT WORLD LONDON

PORTLAND HOUSE

4 GREAT PORTLAND STREET NO:4

LONDON / UNITED KINGDOM

TRT WORLD WASHINGTON D.C.

1819 L STREET NW SUITE 700 20036

WASHINGTON DC

www.trtworld.com

researchcentre.trtworld.com

Introduction

Fans of Harry Potter movies will remember the Grand Staircase and its constantly moving stairs. Stairs, parted apart to break the existing links and came together to form new ones. Today's global trade environment resembles the Grand Staircase, and moving stairs are like supply chains—the global trade environment witnesses partition and the formation of new links. However, unlike the Grand Staircase, new connections in international trade are formed not randomly but rather deliberately.

Recently, disruptions took place, causing significant impact. There are many reasons for such a situation:

1. Global trade witnessed a rise in trade tensions. The US and China point fingers, accusing each other of unfair trade practices, protectionism, and economic coercion. Accordingly, they take measures, such as subsidising industries, introducing tariffs, and restricting trade to protect their economic and national securities.

2. The multilateral system is eroding, and the focus is shifting towards a bilateral or multilateral system that involves groups with fewer countries. For instance, the bastion of the multilateral trade system, the World Trade Organization's (WTO) dispute settlement system, has not been functioning for a long time. Such a situation means the deterioration of rules-based trade relations among countries due to less consideration of WTO's rules.

3. Climate concerns are increasingly taking centre stage. Countries swing between environment-friendly countries and unfriendly countries with cheap energy.

4. Countries are still struggling with the consequences of the Covid-19 pandemic. Following the Covid-19 pandemic and China's zero-Covid policies, businesses continue diversifying their supply chains to avoid future shocks.

5. Finally, Brexit, the Russian invasion of Ukraine, the ensuing energy shock, and events such as the US withdrawal from the Trans-Pacific Partnership are the finishing touches shaping the links. All those lead to the reorientation of global supply chains.

In such an environment, developing countries try to benefit most from supply chain reorientation. The industries that are most affected by such change of direction are the tech and big pharma given their cruciality for national and economic security.

The new realities of the world also indicate that there will be no such thing as "being the new China" or, in other words, being a one-stop-shop country for all manufactured goods. The world is moving towards multiple countries as nodes within global supply chains. Those with strategic locations, cheap and abundant labour, and political and economic stability will play a significant role, while those lacking adequate regulations, quality products, and affordable energy will be ignored.

The new realities also risk reinforcing poor labour standards, lax environmental policies, and corrupt practices. Search for cheap labour and energy creates that risk as poor labour standards, flexible ecological guidelines, and unethical approaches lower the prices. However, this situation harms people and the environment in the short and long term. Therefore, this aspect should be considered while reorienting supply chains.

This discussion paper will review the current chain supply reorientation, focusing on the tech and pharmaceutical industries in three countries: Vietnam, India, and Mexico.

China 2.0: Still important but Not Indispensable

China's dominance in global supply chains has been seriously dented, causing the reorientation of supply chains, increasing labour costs in China, and the shipping crisis. Nevertheless, it seems unlikely that China will be dethroned any time soon. Because so far, no other country matches China's enormous manufacturing base ("Global Firms are Eyeing Asian Alternatives", 2023). China still usually provides cheaper products to the world, especially in certain sectors such as pharmaceuticals. Moreover, China is an important source of rare earth elements, including gallium and germanium, which are essential, especially for the tech industry, and active pharmaceutical ingredients crucial for the pharmaceutical industry.

There may not be an alternative to China on the horizon. Still, the trajectory of the global trade environment suggests that China's mighty days are history. Depending on a single country for manufacturing because it is cost-effective is no longer on the table because of strategic reasons. Instead, many consider multiple sourcing as the best option to preserve the stability of supply chains. Therefore, neither China nor any other country can be as indispensable anymore. The debate on which country will be the new China is meaningless, as is the quest to become a new China. Instead, developing countries must analyse the qualities that make them preferable in multiple sourcing and take the steps accordingly.

The Favourites

Some qualities are essential in attracting investment. Stability and trust have become important, almost as important as providing cheap manufacturing opportunities. Friendly relations and location are other qualities that gained currency. Friendshoring and nearshoring are on the rise. That's why Vietnam and Mexico have become more attractive to many countries. Those countries are also popular because they provide incentives, are signatories of free trade agreements, and are developed in terms of infrastructure.

Vietnam is among the most favoured countries for the ongoing supply reorientation. It has a lot of arguments in its favour: a well-educated population, abundant and cheap labour, and a good geographic location, to name a few. Other advantages include the country's free trade agreements, CPTPP and RCEP,[1] political stability, economic reforms, and determination to combat climate change (The US Department of State, n.d.). Tech and healthcare companies appreciate these upsides. In the first half of 2023, the processing and manufacturing industry and science and technology sectors were among the first three sectors which attracted foreign investors (Socialist Republic of Vietnam Ministry of Planning and Investment, 2023).

For instance, Samsung is attracted by Vietnam's offering. That's why it is among the largest foreign investors in Vietnam (Duc, 2023). Samsung's journey in Vietnam started in 2008 ("Samsung", n.d.). From there on, it only continues to increase its investment in the country. The company opened its largest Southeast Asia research and development centre in Hanoi (Jaewon & Hoang, 2022) and plans to invest an additional $2 billion in Vietnam (Duc, 2023). An increase in Samsung's investments is anticipated. Vietnam is close to China, with good port and rail links, and has low-cost and high-skilled labour (Barnes, 2023). Samsung receives significant incentives, such as preferential tax rates and infrastructure leasing (Lăng, 2022). Moreover, as approved and announced by the Communist Party in 2021, the recent economic strategy focuses on directing more foreign investment to high-tech industries (The US Department of State, n.d.), which is to the benefit of Samsung. Similarly, Politburo's Resolution 55 of 2019 aims to increase the effectiveness of the energy sector, which also benefits Samsung (Politburo, 2020).

Similarly, Mexico is among the preferred recipients for supply chain reorientation. It provides cheap labour, cheaper than China in most cases, and lands at the doorstep of the US, which hosts the world's largest and most innovative companies ("The Americas Face a Historic Opportunity", and its proximity with the US enables easy logistics, as well as cheap labour. As such, many companies are considering relocating their facilities to Mexico. Mexico's economy minister stated last year that about four hundred

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businesses were interested in moving operations from Asia to Mexico ("The Americas Face a Historic Opportunity", 2023). Importantly, Mexico is a party to many Free Trade Agreements, including the USMCA.[2] Mexico also offers a large internal market and maintains prudent monetary and fiscal policies (Torres & Jayashankar, 2023), which help maintain a safer environment for investors.

Mexico's automobile industry is especially strong. For instance, Mexico supplied 42% of the auto parts to the United States between 2018 and 2022 (Torres & Jayashankar, 2023). Tesla is among those companies. In early 2023, Musk announced that Tesla plans a gigantic new plant in Mexico worth more than $5 billion ("Tesla Plans Gigafactory", 2023). Tesla's decision is based on a desire to reduce manufacturing costs and gain a competitive advantage (Nacla, 2023). Other manufacturers, such as BMW, GM, and Ford, have also announced their plans to produce Electric Vehicles in Mexico ("Tesla Plans Gigafactory", 2023). These companies are attracted by the huge profit margins created by persistent, long-term forms of affordable labour (Nacla, 2023).

Finally, strong internal demand, abundant labour, and pre-existing industrial capacity determine the direction of the reorientation of supply chains. India is, therefore, increasingly considered a good alternative to China in the pharmaceutical industry. It is a populated country with 1.5 billion people. That means a large domestic market and internal demand, and therefore, the ability to foster business within the country. That also means a vast workforce for manufacturing. It already has a strong pharmaceutical industry. In 2021, India ranked 12th worldwide for its pharmaceuticals exports (in worth) ("Pharmaceutical products", n.d.). The main importers of Indian pharmaceuticals were the United States, the United Kingdom, and Russia ("Pharmaceutical products", n.d.). It is one of the world's largest suppliers of low-cost vaccines and the biggest supplier of generic medicines (Ministry of Chemicals & Fertilisers Department of Pharmaceuticals, 2023).

India's advantages further promote its industry. The government provides incentives, including Production Linked Incentive Schemes (PLI 1.0, PLI 2.0, and Bulk Drug

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Park), for promoting domestic production of essential Key Starting Materials and APIs (Invest India National Investment Promotion & Facilitation Agency, 2023a). The country is an expert in low-cost manufacturing of generic drugs and end-to-end manufacturing. It has the most US-FDA "compliant plants outside the US" (Invest India National Investment Promotion & Facilitation Agency, 2023b). Due to the National Health Production Scheme, the country has a strong domestic demand (Invest India National Investment Promotion & Facilitation Agency, 2023b).

Moreover, the country's reintroduction of pharmaceutical patents reassures companies that their products will not be subject to reverse engineering. Lastly, the government established a suitable regulatory framework, especially for generic pharmaceutical manufacturers. All these qualities, in total, make India and other countries an attractive place for supply reorientation.

The Picture is More Nuanced

No country is perfect. Every country, even the ones with many advantages, has some shortcomings that deter investment or at least make the investors think twice. For example, Vietnam struggles with its property sector's worsening debt crisis (Trivedi, 2023), the slow shift from low-cost to high-tech manufacturing (Samuel, 2023), the ineffectiveness of and corruption within state-owned enterprises. Other disadvantages of Vietnam include shortcomings of and inconsistencies in the legal framework, lack of judicial independence, over-dependence on China (The US Department of State, n.d.), as well as regulatory uncertainty in essential sectors, and the government's slow decision-making process (APFL & Partners Legal Vietnam LLC Law Firm, 2021).

India has likewise some disadvantages, especially within the pharmaceutical industry. The most significant disadvantage is the country's overreliance on APIs and intermediate and producer goods from China (Sakaria & Rishabh, 2023). For instance, in the first nine months of 2022, China supplied about 66% of India's APIs (Sakaria & Rishabh, 2023). That makes imports from India costlier than imports from China.

Second, during the Covid-19 pandemic, India banned its paracetamol exports. Such abrupt decisions worry the countries searching for a trusted partner. Evidently, the pandemic posed an exceptional situation, and India's huge population led to that decision. However, such a step should be judged in light of India's past actions. In the past, India has abolished the patent protection of pharmaceuticals to strengthen its national industry.

Moreover, India refused to join RCEP. Joining the RCEP would benefit India by creating jobs and being part of global value chains (Gupta & Ganguly, 2020). Instead, India preferred to act with protectionist concerns in mind (Gupta & Ganguly, 2020).

Furthermore, the country's pharmaceuticals and patent regulations are still desirable. Shortcomings around regulations pose challenges for the industry. Above all, in India, regulatory compliance is time-consuming and resource incentive. Drug regulations are ill-equipped to regulate India's complex market, which assembles a federation of states (Krishnan, 2022). Regulatory compliance is inefficient and ineffective; at worst, it leads to corruption (Krishnan, 2022). Especially the lack of stable policies and defined regimes around pricing complicates compliance and negatively impacts pricing strategies and profitability ("The pharma industry's quality and regulatory challenges", 2023).

There are also issues around the safety and quality of pharmaceutical products. India is the main source of counterfeit medications (OECD & EUIPO, 2020, pp. 38 - 40). In 2016, 53% (in value) of counterfeit pharmaceuticals originated in India (OECD & EUIPO, 2020, pp. 38 - 40). In recent years, India has been hit by many pharmaceutical safety scandals. In 2020, seventeen children died in India from consuming a contaminated syrup made by a company called Digital Vision (Krishnan, 2022). In 2022, Maiden Pharmaceuticals Limited's syrups were suspected of being responsible for the deaths of sixty-six children in the Gambia (Biswas, 2022). All these prevent the reorientation of supply chains to India with 100% trust.

Finally, Mexico's disadvantages represent the importance of reliable and cheap energy. Access to affordable, clean, and reliable energy is limited in the country (Soto & Coym, 2023). Regulations around electricity give an advantage to state-owned enterprises (Soto & Coym, 2023). CFE, Mexico's state electricity company takes priority, and, therefore, the private sector loses its competitive advantage (EY Parthenon, 2020). That means scarce and more expensive energy.

Mexico and the other two countries show that each country has pros and cons. The reason why countries are still preferred despite their disadvantages is that their advantages outweigh their disadvantages. More importantly, countries take steps to mitigate their disadvantages.

Neglected Issues

Developing countries want to do their best to capitalise on the global reorientation of supply chains. To that end, they are ready to go the extra mile to remove obstacles. There is no doubt that efforts to remove obstacles have benefits. Such benefits include encouraging countries to ensure stable economic and political policies. Establishing solid legal and regulatory frameworks is another benefit. Benefits also include compelling countries to address logistics and infrastructure-related problems too.

However, it is not all about benefits. The desire to capitalise reorientation of supply chains also leads to harmful practices. The exploitation of labour is among these downsides. In many developing countries, the demand for cheap labour leads to poor working conditions, long hours, and insufficient wages. For instance, in the garment and textile sectors in Vietnam and India, workers face hazardous conditions and low pay. For similar reasons, the US has often asked Mexico to review labour rights at certain facilities, among which is Grupo Yazaki Auto Components Factory (Office of the United States Trade Representative, 2023).

Ignoring environmental degradation is another harmful practice. Environmental regulations in Mexico, Vietnam, and India are inadequate, and this is due to the aspiration to attract investment. Because in these countries, companies do not have to spend billions to comply with environmental standards. As a result, pollution levels, and deforestation increase, improper waste management subsists, and those impact local ecosystems and public health. For example, the rapid expansion of manufacturing industries in certain regions of Vietnam has led to severe pollution of air and water resources, adversely affecting local communities and biodiversity.

Finally, the pursuit of investments may exacerbate corrupt practices. Such may undermine transparency and accountability, hinder fair competition, and deter responsible investment. Companies may operate with impunity in such environments, exploiting resources and labour without adequate safeguards. This situation can perpetuate a cycle of economic dependence, as short-term gains from lenient regulations and corrupt practices may outweigh long-term sustainable development goals. Ultimately, these detrimental practices impede developing countries' social, economic, and environmental progress and hinder their ability to achieve inclusive and sustainable growth.

Conclusion

The reorientation of international supply chains occurred for many reasons, including the Covid-19 pandemic, trade wars between China and the US and the fragmentation of global trade. Many countries seek an alternative to China to diversify their supply chains within such an environment. The snapshot of today's global trade scenery proves there will not be such a thing as new China. But countries with certain advantages will take their share from the reorientation of global supply chains. Mexico, Vietnam, and India are good cases in point.

Proximity to the US and China is advantageous. Other pros include abundant and cheap labour, being part of free trade agreements, and incentives provided in a country. Internal demand and structured laws and regulations are useful, as India proves. Finally, tackling shortcomings such as weak legal frameworks, lack of judicial independence, and over-dependence on China, can give the edge. Industry-specific drawbacks, such as low-quality standards in pharmaceuticals, are detrimental to India.

Meanwhile, the quest for getting a piece of the pie of global supply chain reorientation causes poor labour practices and subpar environmental policies because they lower the cost of manufacturing. Similarly, corruption is expected to increase. Therefore, such concerns must be addressed before it is too late.

[1] CPTPP (Comprehensive and Progressive Agreement for Trans-Pacific Partnership) is a free trade agreement. The members of the Agreement are Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, Vietnam, and the UK (subject to ratification). The Agreement simplifies member commerce by offering zero tariffs for over 99% of exports between CPTPP members. RCEP (Regional Comprehensive Economic Partnership Agreement) is a regional free trade agreement. The members of the Agreement are Australia, Brunei Darussalam, Cambodia, China, Japan, Laos, New Zealand, Singapore, Thailand, Vietnam, the Republic of Korea, Malaysia, Indonesia, and the Philippines. Around 92% of goods traded among RCEP Parties are not subject to tariffs.

[2] USMCA (The US – Mexico – Canada Agreement) is a Free Trade Agreement. The members of the Agreement are the US, Mexico, and Canada. The Agreement includes provisions around intellectual property rights, eliminates tariffs in many sectors, reduces paperwork, and facilitates trade, all of which reduce costs and increase the trade volume.

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