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Limits to supply chain diversification

Emerging trends demonstrate intensification of indirect supply chain integration with China

The supply chain agreement signed earlier this month by all 14 Indo-Pacific Economic Framework (IPEF) member countries within 18 months of its launch is commendable. Recent systemic shocks and geopolitical events have caused major disruptions in supply chain operations, with consequent impacts on the flow of goods and services, including essential commodities like food and medicines. Preventing disruptions and ensuring supply chain resilience is, therefore, an important objective for most developed and developing nations.

The agreement aims at establishing three new bodies: The IPEF Supply Chain Council, a supply chain crisis response network, and a labour advisory board. The Council will identify “critical sectors” and “key goods” and develop sector-specific action plans that will include, among others, diversification of input sources, joint research and trade facilitation. The network will essentially provide an emergency communications channel in a supply chain crisis situation in a member nation. Prior detection of potential and latent stress points and vulnerabilities across the supply chain network will be undertaken to prevent any future disruptions. The advisory board, comprising government, worker and employer representatives, will work towards promotion of labour rights and issue advisories on best practices in this respect.

The constituent provisions, while ensuring a comprehensive coverage of preventive measures against supply chain disruptions, are non-binding, thus providing no guarantees towards achievement of the stated objectives. This is a key difference compared to standard free-trade agreements. The provisions also allow for several flexibilities, especially in situations where a country deems it fit to apply measures or not provide information to protect its essential security interests. Considering that this has been the

rationale for the imposition of most trade-restrictive and inward-looking industrial policy measures over the last few years, the agreement may fall short in ensuring a rules-based trade order in the region and hence the broader strategic objective of the IPEF.

There are other aspects of this primarily recommendatory agreement that may impede its implementation. As the IPEF agreements are executive agreements and do not require congressional approval in the US, there is the all-important question of its viability across administrations, especially given that the US Presidential elections are due in a year's time, and recent statements by former President Donald Trump are indicative of his intent to bring the agreement to naught if re-elected.

The emergency communications channel to ensure a coordinated response in case of supply chain crisis in any member economy is probably the most significant element of the agreement. Successful implementation would require precise and accurate demand projections of critical inputs, maintenance of sufficient levels of safety stocks, and diversification of sources alongside ensuring smooth logistics in and across member nations. However, these preconditions may not be easy to fulfil. Finding efficient

substitutes of critical inputs among the set of friendly IPEF member economies may not always be possible, and formidable costs involved could be a major deterrent to creating resilient supply chains.

In a recent study, Freund *et al*¹ show how supply chain diversification is evolving at variance with policy rhetoric. Through an econometric analysis of highly disaggregated trade data, including for strategic industries (defined as Advanced Technology Products by the US government), from 2017 to 2022, they study the impact of higher US tariffs on imports from China and its impact on global supply chains. Their findings

show that even as China's share of US imports in the tariffed category of products falls, there is little evidence of reshoring of production back to the US. The difference in imports from China is more than made up by imports from other countries. More interestingly, a majority share of this shift in sourcing imports is towards a single supplier, and this holds true, to a larger extent, for strategic products. So, single-source dependence persists. Furthermore, the shift away from China as a source of imports is to countries that have the deepest supply chain linkages with China. This is especially true of the major beneficiaries in this shift — that is, countries that gain most in terms of export share to the US, such as Vietnam in electronics. In strategic sectors, expansion of exports to the US, also leads to increased supply chain integration with China for these major beneficiary economies. So, while the US' dependence on direct imports from China has seen a decline, indirect imports may be as much or more than earlier. The reconfiguration of supply chains as a consequence of US import tariffs is thus not in line with the policy objective of reduced import dependence on China.

With regard to friend-shoring, the authors similarly observe that integration with Chinese supply chains emerges as among the strongest indicators to identify the “plus one” economy. In case of strategic sectors, in addition, supply chain integration with China increases as exports to the US increase. So, while direct decoupling from China may be happening, indirect value chain integration is observed to have been strengthened, especially in strategic sectors.

Dahlman and Lovely (2023)² make similar observations for the IPEF economies. Based on detailed bilateral trade data in the period 2010-2021, they show that trade for the IPEF countries, particularly those emerging as alternative production locations to China, is concentrated across a smaller set of import sources and export destinations. In addition, economic ties of the IPEF countries show increasing reliance on China, which is also the top source of import for all member economies, except Brunei. The increase in imports from China during this period is the highest for Vietnam, Malaysia, India, and Indonesia.

Emerging trends thus demonstrate that the scope for substitutability of imports across trade partners is limited, and the shift to alternative production locations typically leads to intensification of indirect supply chain integration with China. So, the IPEF supply chain agreement, which is essentially structured around voluntary coordination and consultative mechanisms, even though well-intentioned, is unlikely to go very far in ensuring significant supply chain diversification and hence resilience.



STRAIGHT TALK

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1. Freund, C, A Mattoo, A Mulabdic, M. Ruta, *Is US Trade Policy Reshaping Global Supply Chains? World Bank Policy Research Working Paper 10593*, October, 2023.

2. Dahlman, A and ME Lovely, 2023, *US led effort to diversify Indo-Pacific supply chains away from China runs counter to trends*, Peterson Institute of International Economics