

The Great Unwinding

Covid-19 and the regionalisation of global supply chains

A report by The Economist Intelligence Unit



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Covid-19 will fundamentally reshape trade, accelerating the trend towards shortening supply chains. Just-in-time manufacturing using global suppliers will give way to a greater focus on use of regional supply chains, strategic use of inventories and a new approach to viewing risk in the C-suite.

Part 1: Covid-19 and the global supply chain

Challenging the location of production

The global economy is highly dependent on China. China's share of global trade in some industries exceeds 50%—in the global trade of telecommunications equipment, for example, China's share (by volume) was 59% in 2018. China's importance in global trade and supply chains has grown ever since it was accepted into the World Trade Organisation in 2001. This led to the latest wave of globalisation as multinationals took advantage of the trading opportunities that China offered, both in terms of production and as a source of demand for their products. However, as a result of Covid-19, it is likely that this period of globalisation will not only come to a halt, it will reverse.

The US-China trade war and rising wages in China had already incentivised some multinationals to relocate their supply chains away from China to other parts of Asia; the textile sector was an early example of this trend. Covid-19 will push more companies in other sectors to relocate parts of their supply chains. The outcome of this will be an Asian supply chain network that is both less China-focused and more diverse. This is a prelude to what will happen in other regions as global companies look to build resilience into their supply chains. By building quasi-independent regional supply chains in the Americas and Europe, a global company will provide a hedge against future shocks to their network. For those companies that have this luxury already, they have been able to shift production of key components from one region to another as lockdowns and factory closures resulting from coronavirus have unfolded. Supply chains are difficult to set up and even more difficult to move, especially in the automotive sector. As more firms make this decision, therefore, the shift to regionalised supply chains will be an enduring outcome of this crisis.

Optimising transportation and storage for risk mitigation

The issue of a globalised or regional supply chain is not the only tension that Covid-19 will expose. Another core decision for multinationals is the timing of production and assembly of products along the supply chain and, relatedly, the storage of either intermediate or final goods throughout this process. For the sake of efficiency, multinationals tend to optimise the logistics process of their supply chains to minimise storage costs. However, in a world of increasing uncertainty and ongoing risk, a sole focus on the efficiency of transportation and production will leave firms vulnerable to shocks. In the current crisis, companies are seeing greater value in storing inventory in strategic locations from where it can be easily accessed and delivered to customers. This approach applies to final goods but also to strategically important components, such as those that can be only sourced from one market.

Maintaining a strategic stockpile of final goods and critical components has helped some companies to deal with the impacts of coronavirus. As the memory of the current crisis fades in the coming years, the practice of maintaining strategic stockpiles may diminish. However, the need to monitor supply chain resilience in respect to stocks and to maintain the flexibility of storage is an area of supply chain management that will endure.

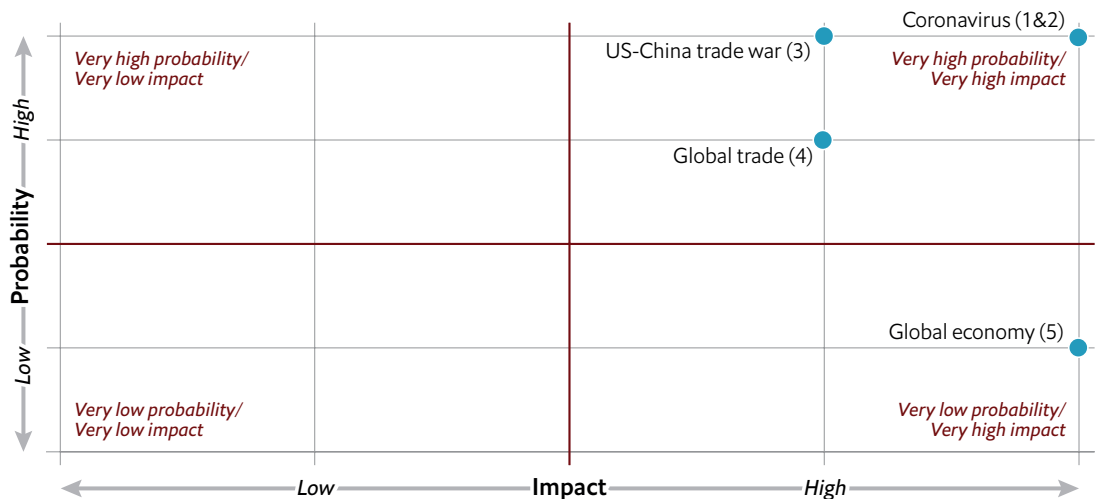
Part 2: How multinationals can respond

1. Scenario planning

In an increasingly perilous global economy, global trade has been growing in risk for many years. Scenario planning has become more prevalent as risk has grown, and sophisticated use of tools related to this will be crucially important as multinationals confront the impact of Covid-19. The initial outbreak of coronavirus caused factory closures and disruptions to supplies in many sectors, but the picture facing multinationals will not be limited to supply concerns. The Economist Intelligence Unit expects the global economy to see a steeper decline in output than followed the global financial crisis of 2007-08, with a slow recovery to follow, implying that demand for a range of goods and services will be significantly curtailed in 2020. Companies will therefore be faced with the simultaneous challenge of both supply and demand disruptions. Scenario planning techniques will be central as businesses seek to limit the impact on their supply chains and match goods to markets at a time when consumption possibilities are highest.

Scenario	Probability	Impact	Intensity
The uncontained spread of the coronavirus drives the global economy into an economic depression	Very high risk	Very high	25
The response to the coronavirus leads to a string of sovereign defaults and financial contagion	Very high risk	Very high	25
An escalating US-China trade war forces a split in the global economy	Very high risk	High	20
Global trade is hit by open economies permanently reverting to anti-globalist policies	High risk	High	16
The global economy bounces back quickly as the coronavirus proves to be less damaging than expected	Low risk	Very high	10

Source: The Economist Intelligence Unit.



Source: The Economist Intelligence Unit.

2. Digitalisation of business models

Companies are adapting their business models both out of necessity and opportunity. For example, consumer goods companies, which have seen their offline stores close around the world, have moved to target potential customers with online activities in an effort to increase sales. Another example is restaurants, which in many countries have been unable to operate as they were before the crisis, with many expanding their delivery options to give them the potential to reach more customers. These responses to Covid-19 highlight the importance of e-commerce and the need for businesses to improve their online presence for customers.

Moves by firms to enhance their online presence will force many companies to devote more attention to understanding their customers as they seek new channels to meet their needs. Consumer habits that are being formed in 2020 are likely to endure, and companies will have to continue to develop their e-commerce platforms and find efficient ways to distribute their products to consumers.

Similarly, multinationals will increase their use of data in the production process, leading to the increased digitalisation of supply chains. We are likely to see companies make efforts to reduce the reliance on paperwork and create a more data-driven supply chain. However, this presents its own challenges, as different systems operate in each country and current border controls are heavily reliant on paperwork. Persuading suppliers throughout the chain to provide their data will also be vital for full visibility, but this will raise privacy and competition issues.

3. From tactics to strategy

The decision by companies to focus on online connections is a tactical response to Covid19. However, the best-prepared companies will be those that also plan strategically for the new normal that will emerge after the crisis. A more sophisticated online presence will open new opportunities for many companies as they are able to reach customers that were previously unattainable. Moreover, for companies in the manufacturing and consumer goods sectors, opportunities will be available to join regional supply chains as dominant companies in these sectors restructure their global networks. This will be particularly relevant for small and medium enterprises.

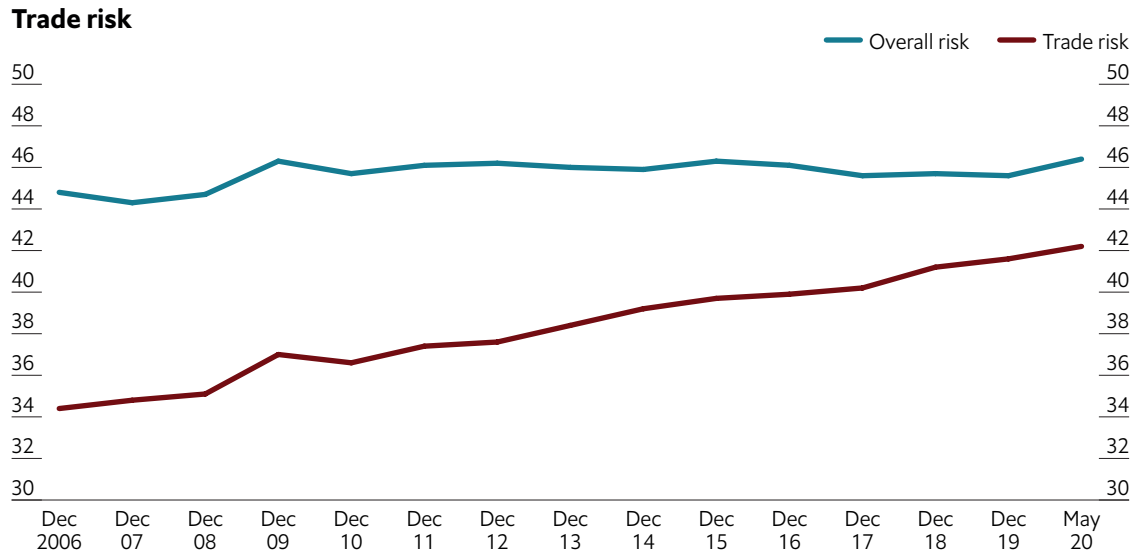
Companies will also need to think strategically about pricing models. Both the regionalisation of supply chains and the build-up of strategic inventories will push up final goods prices, denting a product's competitiveness. A more regionalised supply chain will offer opportunities for companies to focus more on local tastes amid a greater capacity for product differentiation. In the medium term this may offer companies the ability to reach higher price points for their products, potentially offsetting the increased production costs from regionalising supply chains and holding larger inventories.

4. Bring risk management to the company's core

One of the lasting impacts of Covid-19 will be a greater focus on risk in multinationals. However, this is not without its challenges. Whether it is regionalising a supply chain or appointing a Chief Risk Officer, the immediate return on these investments will be hard to see. Rather, as more time passes after the worst of this pandemic, the apparent need to invest in risk-related practices will decline. But reverting back to a sole focus on growth with little regard for risk would be a mistake, as the global economy was already being buffeted by uncertainty before the current pandemic.

THE GREAT UNWINDING

COVID-19 AND THE REGIONALISATION OF GLOBAL SUPPLY CHAINS



Source: The Economist Intelligence Unit, Risk Briefing.

Geopolitics had risen in recent years to be the dominant theme of the global economy—the ongoing US-China trade war is the clearest example of how sparring global players can unsettle the global business environment. The trade war is likely to continue after the US election in November 2020, regardless of the outcome, as issues of technological dominance drive tensions between the world’s two largest economies. Climate change will also grow in importance for multinationals. We forecast that the economic impact from climate change will result in a global economy that is 3% smaller in 2050 than the counterfactual with no climate change, and the prevalence and severity of natural disasters will increase in the coming decades. For many reasons, therefore, managing risks with the aim of avoiding severe threats to operations will remain a central requirement for multinationals.

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