Rising regionalization: will the post-COVID-19 world see a retreat from globalization?

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Concerns regarding the operation of the global economy mean that recovery from the COVID-19 pandemic is unlikely to see a return to the previous globalization wave. We suggest that there is an opportunity to address some of the weaknesses of globalization through a more regionally-based world economy offering a better balance between national and international interests, efficiency and resilience in global supply chains, and between growth, inclusiveness, and equity impacts.

Keywords: COVID-19, globalization, regionalization

1. Introduction

The COVID-19 pandemic represents the most fundamental disruption to economic activity in a century, introducing huge challenges for the global economy. Although that economy has survived past disruptions – 9/11, severe acute respiratory syndrome and the global financial crisis – none have been as immediate, prolonged or widespread as the pandemic. Unlike earlier events, it has simultaneously hit the leading economies, paralyzed links between countries, prompted a mix of responses and created uncertainty about its eventual eradication. Interestingly, for a global event, it has not triggered an effective global response. Rather, nations have pursued disparate responses based on their trade-off between the costs of virus containment and those of economic shutdown and isolation. The lack of global leadership may reflect the absence of a clear single global power or the ongoing tensions between the two leading contenders – the United States and China.

One effect of the pandemic is a reconsideration of the current globalization wave and whether it should be revived or remodelled. Globalization was already subject to considerable criticism prior to the pandemic (Buckley and Hashai 2020). Concerns highlighted its inequity, its fragility, its encouragement of wastefulness and disregard for the environment, as well as its relentless drive to advance technology. These

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concerns brought the growth of nationalism, populism and challenge to the United States’ economic hegemony, triggering increased protectionism and a rejection of the institutional arrangements that have guided the world economy since 1945 (Walt 2020).

This paper takes the position that we will see attempts to remodel globalization, with a move towards a more regionally-based world economy, seeking a better balance between national and international interests (Rodrik 2019), between efficiency and resilience of supply chains (Reeves and Varadarajan 2020) and between growth and equity (Gruber 2011). We believe that there is growing credence to the view that a regionally-based economy could offer some of the benefits of recent globalization (sustained growth, poverty reduction), and fewer of the detrimental effects (hypergrowth, rising inequality, environmental degradation and ineffective responses to global issues).

We first consider the forces affecting globalization prior to the outbreak of COVID-19, highlighting long-running anxieties. We then outline some of the expected changes to globalization as the world economy experiences recovery. Revival may favour growing regionalization, and the factors encouraging such a trend are discussed. The downsides of a more regionally-based global system are examined and concluding considerations presented.

2. Was globalization already overextended?

Prior to the disruption caused by the pandemic, there were indications that the current globalization wave may have reached its peak (Livesey 2018; Witt 2019). To thrive, globalization requires favourable conditions – a relatively free and non-discriminatory trading environment, low tariffs, efficient market processes and supporting institutions, and a comparatively stable operating environment, at least one characterized by manageable risk rather than disruptive uncertainty. In addition, the most recent globalization wave also required efficient infrastructure, both physical and digital, as well as sophisticated technologies to coordinate complex global supply chains and opportunities to exploit locational advantage. Changes in any of these alter the attractiveness of global business strategy. In recent years, a weakening of policy elements has become evident. There are numerous and conflicting arguments surrounding the underlying causes of these shifts – the United States’ focus on military primacy (Wertheim 2020), the lack of economic convergence between countries (Rodrik 2019) and the fact that political convergence has always lagged economic integration – but the result has been a marked deterioration in policy underpinnings of the international economy.
The deterioration is evident in a number of ways. International institutions designed to bolster cross-border exchanges have been weakened through ongoing criticism, obstructions and the withholding of funding. The World Trade Organization appears weak, subject to criticism and the blocking by the United States of appointments to its Appellate Body (Yacoub and El-Zomor 2020). Similarly, the World Health Organization has seen its funding from the United States halted amid criticism that it was slow to respond to the pandemic and uncritical of China’s role. The United States has reduced confidence in the integrity of trade agreements and alliances with its withdrawal from the Trans-Pacific Partnership and its contentious renegotiation of the North American Free Trade Agreement (Lawder and Freifeld 2018).

The recent increase in global protectionism has affected trade (Quaglietti 2018), international investment screening (Wernicke 2020), global value chains (GVCs) (UNCTAD 2020) and technology transfer (Sukar and Ahmed 2019). This backlash is linked to the subservience of the nation State to global interests in a world of hyper-globalization (Rodrik 2019). Empirical data support the view that de-globalization had begun prior to the pandemic (Witt 2019). World trade fell sharply after the global financial crisis. While trade has recovered somewhat, trade as a percentage of gross domestic product (GDP) has not, falling since 2008 in a period sometimes termed “slowbalization” (Irwin 2020). Comparable declines in real foreign direct investment (FDI) and GVCs have also occurred (UNCTAD 2020).

De-globalization carries a cost. Globalization has brought high growth rates for a number of emerging economies (Crafts 2004), lifted hundreds of millions out of poverty (Salvatore and Campano 2012) and provided consumers with greater choice and lower prices for a wide range of goods and services. These benefits must be incorporated into any consideration of the true costs of moving towards a more regionalized economy.

3. Changes in the nature of globalization

The underlying weaknesses outlined earlier brought pressures for change that were exacerbated by the pandemic. Several changes in the nature of globalization are already evident. First, State involvement in economic activity has increased noticeably. State support has morphed into State direction as businesses are ordered to produce critical products (ventilators, personal protective equipment), to reconsider production locations and to increase supply resilience. These policies, designed to improve national security, are affecting globalization. Japan has set aside more than US$2 billion to assist its firms in shifting out of China, relocating either home (reshoring) or somewhere else in the region (nearshoring) (Bloomberg 2020). Japanese firms that experienced supply chain shutdowns are reconsidering
arrangements. Iris Ohyama is shifting its mask production from China to Japan, while Mazda has indicated that it will source auto parts more often from Mexico. Similar calls have been made in the United States, with White House National Economic Council Director Larry Kudlow calling for the authorities to pay the costs for United States firms to move operations home from China. Although some relocation has occurred, primarily because of rising labour costs, it has been modest and recent surveys show that many firms remain committed to China (Erchi et al. 2020). The costs of relocation are considerable, in part because many multinational enterprises (MNEs) do not own production processes that can be transplanted. Rather, they rely on a network of contract suppliers and assemblers who produce on their behalf. In some cases, the firm may have lost the competence to manufacture at home, or anywhere else. More likely is a strategy of greater diversification within the Asian region, often a China-plus-one strategy (Enderwick 2011) that strengthens the regionalization of supply chains. For example, Japanese automobile firms are favouring Thailand and Indonesia, machinery firms are targeting Vietnam and semiconductor manufacturing is looking to the Philippines. A strategy of greater diversification still enables MNEs to benefit from China, as China’s trade with the ASEAN group (the Association of Southeast Asian Nations) now exceeds its trade with the United States or Europe, and specialist manufacturers and contract assemblers such as Foxconn and Pegatron increasingly commit to Vietnam, India and Indonesia (Chow 2020).

A second major change affecting globalization is a result of firms reconsidering the resilience of their global supply chains. The most recent global wave demonstrated that although supply chains manage continuous adaptation, they struggle with what Rumelt (2009) termed “structural breaks” such as the COVID-19 pandemic. The expansion of GVCs has been driven by efficiency considerations, exploiting extreme specialization and locational disparities. The result has been long, fragmented, but often geographically concentrated supply lines. Optimization at each value-adding stage is assumed to result in comparable system optimization, with system dynamics an operational constraint. However, extreme fragmentation, increased connections and growing environmental volatility mean that local disruptions have unpredictable system-wide effects. Digital ties and coordination of such systems simply accelerate the transmission of shocks (Reeves and Varadarajan 2020). Even the management of GVCs has contributed to the risk of costly disruptions. Academic analysis of the governance of GVC networks has focused on mechanisms, both social (Kano 2018) and strategic (Enderwick and Buckley 2020), that are designed to minimize coordination costs. A strong inward focus has redirected management attention from environmental scanning and the anticipation of external threats.

Third, COVID-19 is likely to affect not just the geography of production, but also the management of supply chains. Outsourcing has minimized margins for many suppliers, making business continuity challenging. The ongoing loss of trusted
suppliers may mean a reconsideration of margins and closer supportive relations along value chains. Technology offers opportunities to restructure supply lines, with frontier technologies such as 3D printing facilitating reshoring or complementary sources of supply. MNEs may seek greater internal flexibility, pursuing reforms of work practices or the use of virtual, transient outsourcing and pop-up enterprises, so-called asset-light strategies (Casella and Formenti 2018). Advanced control and communication technologies enable reduced dependence on key supply hubs such as China. If consumers are willing to accept higher prices, in the same way that they are prepared to pay a premium for fair trade goods, products may be promoted as being sourced from more resilient supply chains, where slack is incorporated, stockpiling is assured or higher supplier margins are guaranteed.

The implications of such changes for countries seeking to join GVCs are unclear. On the one hand, a desire to reduce dependence on traditional hubs could offer opportunities for countries. For example, Ethiopia is rapidly establishing itself as an important location for clothing manufacture. On the other hand, a new member economy in a GVC will need to ensure it has a stable and attractive operating environment with close regional links. Opportunities for upgrading may also be limited where protectionist measures restrict access to technology or prevent MNE investment in specific industries or locations (Buckley, Timmer, Strange and de Vries 2020). Countries such as China may find themselves excluded from GVCs in critical goods such as food, pharmaceuticals and medical supplies. However, these possible developments assume a recovery of the recent globalization wave, the United States-centric wave. It is possible that if the United States continues to reject globalization while China continues to embrace it (given the huge growth benefits China has enjoyed), a more China-centric regime may emerge (Mahbubani 2020), underpinned by an acceleration of the Belt and Road Initiative. In light of the growing concentration of political power and rigidity in decision-making within China’s Central Communist Party, any new regime may be extremely unstable (Pei 2020).

4. Growing regionalization?

On balance therefore, the effect of the pandemic and underlying anxieties about globalization will push the world economy towards a more regionally-focused composition. This implies selective rather than wholesale de-globalization and is consistent with the long-running argument that from the perspective of MNE strategy at least, the world economy was better described as regional rather than global (Rugman and Verbeke 2004).
One effect of the pandemic has been to reinforce the notion of the nation State. Although the demise of the Soviet bloc created a world defined by nation States, it is at this level that medical, security and economic responses to the pandemic have originated. The considerable diversity of responses underlines national differences in the face of the unknown. The notion of a world of nation States is attractive in many ways. It provides the foundation for democracy and the provision of public goods (Wimmer 2019). But it also has its shortcomings. As an efficient economic unit, many nation States are too small or lack the diversity of economic resources needed for self-sufficiency. The rejection of outsiders also fuels resentment and, historically, conflict. Regional groupings that are based on trade agreements or closer economic relations offer a possible solution to these shortcomings. Regional groupings, often geographically clustered, attempt to bring together those with shared interests, with the European Union being perhaps the best example.

The downside of regionalization is the perceived loss of sovereignty and the erosion of national culture when decisions are taken by those with little or no national accountability. Such resentments, as illustrated by Brexit, have been fuelled by hyper-globalization, which has subsumed national interests at the expense of global gains (Rodrik 2019). However, the price of such gains and the massive inequities in their distribution (Milanovic 2018), have brought domestic disintegration – with rising nationalism, populism and trade protectionism – to a number of countries.

Regionalization is occurring as the United States seeks to decouple from China, limiting access to critical assets such as technology and raising the costs of market access. These moves may be interpreted as an attempt to improve United States national security, but they also form part of the ongoing battle for economic hegemony motivated by China’s dramatic economic rise. The precise meaning of uncoupling is unclear: there are degrees of uncoupling. A number of countries have broadened their interpretation of critical assets and infrastructure, creating additional impediments to foreign acquisition, particularly in the case of State-owned firms (He et al. 2015). The implementation of tariffs across a wide range of sectors implies a deeper level of uncoupling. Most significant have been attempts by the United States to pressure trade partners to make a commitment to either the United States or China, but not both (Rajah 2019).

Encouraged by growing United States protectionism, East Asia has reduced its dependence on Western markets, with an increasing share of demand now accounted for by China. Trade in intermediate goods, while still important, is matched by increases in final goods destined for the Chinese market. Closer regional integration and self-sufficiency is increasingly evident (Rajah 2019). Further growth in the Belt and Road Initiative will offer new market opportunities for the region. Similarly, powerful new trade agreements such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership and the Regional
Comprehensive Economic Partnership offer future potential for the region. Despite being the engine of growth for the East Asian region, China faces a challenge that other regional members do not. The challenge is to balance interregional sales to markets, including the United States and Europe, with growing intraregional production systems, as Chinese firms expand their operations in East Asia and East Asian producers of intermediate products bolster Chinese manufacturing, a manifestation of what has been termed “chained globalization” (Farrell and Newman 2020). The region is characterized by a high level of State economic direction within a planning regime, and this approach will continue to be used to identify new and promising areas of investment and to tackle gaps in localizing GVCs (Grimes and Du 2020). The strengths of the Asian region are its diversity and its digital leadership. This region will couple innovation with both labour-intensive and Industry 4.0 production technologies. Its weaknesses include its few global brands, the increasing liability of China as a production centre, discrimination in trade and investment policies towards the region, and the vacillation of major economies such as Japan and India.

Complementing a stronger East Asian region, the United States already has in place a trade agreement with Mexico and Canada that offers access to complementary resources, including raw materials and cheap labour. The North American region will pursue growth based on private sector innovation, drawing on efficient venture capital funding, with start-ups strong on branding and marketing. The region has strengths at the two ends of the smile curve (innovation and marketing) but has been hollowed out in the assembly and manufacturing functions. In a reversion to the 1960s, there may be greater utilization of lower-cost locations such as Mexico. Further expansion of United States interests into Central and Latin America would provide access to a range of agricultural products and a growing consumer market. Of course, the significant issues of transnational crime, drug manufacture, State collapse and illegal migration need to be addressed if the United States is to strengthen its immediate geographical region.

Europe is the most comprehensively integrated regional grouping and, despite Brexit, has efficient production systems, affluent consumers and variety of resources. The European region is expected to pursue a model of collaborative growth, with expanding cooperation between State organizations and business. However, the region may slip further in the innovation ranking in relative terms and will be exposed to significant gaps in GVCs.

Less clear is the position of seemingly independent nations, particularly India, the Russian Federation and the United Kingdom, and those such as Japan, in a troubled regional relationship India may provide a locational alternative to China for the production of such goods as pharmaceuticals, auto parts and possibly electronics (Govindarajan and Bagla 2020). However, India is weak in many areas
of manufacturing and in innovation. The strategy of an increasingly global United Kingdom is in doubt in a world that may be moving towards greater regionalization, with the country’s dependence on Europe returning despite it no longer being a member of the European Union (EU).

Increased regionalization would also bring costs. Some of the benefits of recent hyper-globalization, such as high growth rates, reduced poverty and opportunities for lesser-skilled workers, would be foregone (Irwin 2020). The costs of establishing regional supply chains would be considerable, particularly in locations that lack supporting services, specialist suppliers or efficient transport and communication links. Even when established, such chains would likely bring higher costs that buyers would have to be willing to assume. Recovery rates between sectors will vary significantly, with air transport and tourism, for example, being slow, meaning that different adjustment rates would be observed. Where there are sectoral interdependencies, these differences would add to costs. Similarly, the creation of regional value chains will require significant coordination between members of regional blocs.

There are also differences in the costs of creating regional chains that are determined by the nature of the industry involved. Primary industries, particularly those in which resources are locationally bound, will still require global markets and transport links to downstream processors at the regional level. Some regions may seek to reduce their dependence on a limited number of suppliers, as the United States has done with oil. The new technologies encompassed by Industry 4.0 could help regionalize some of the most GVC-intensive sectors by reducing the labour cost component and generating offsetting cost savings. Regional processing industries such as food and beverages will be easier to establish, as they are often able to source upstream inputs locally and to customize products to meet local consumer preferences (UNCTAD 2020). Some of the cost disadvantages of regionalism could be partially offset through the considerable gains that could result from a lowering of barriers on international labour mobility, the most protectionist of all resources. The experience of the EU with relatively free labour movement could be replicated in other locations (Rodrik 2019). Smaller economies could benefit where access to GVC involvement becomes easier because of increased regional specialization and the reduced importance of scale.

A further advantage of greater regionalization would be an enhanced ability to tackle the fundamental inequalities that persist in the world economy. The pandemic has demonstrated the human causes of much of our environmental degradation, with air pollution levels falling dramatically around the world as production was curtailed (American Geophysical Union 2020). The failure of global initiatives to effectively tackle this issue creates the opportunity to focus on policies at the regional level, where responses can be tailored more closely to issues and needs. A similar
argument could be made for income and wealth inequalities. There is a greater chance of success for an EU initiative tackling tax avoidance by transnational digital media firms than for any attempt at reaching global agreement on the issue (EU Commission 2016).

National and regional responses may also be more effective in tackling other gaps that have been highlighted by the pandemic. These include differences in the labour force – in work risk profile, economic status, production of services versus goods, and access to health care. Significant digital gaps are evident that can be addressed only by national investment. Differences in consumer behaviour, particularly in risk averseness, also favour more customized policies with regard to trade-offs in health protection versus economic recovery or border opening. For example, initial attempts to open up cross-border travel and tourism have focused on proximate areas such as the trans-Tasman bubble (Australia and New Zealand) and between the Baltic states. Countries and regions display marked differences in their probable recovery rates and likelihood of a viral resurgence (World Bank 2020). Although economic recovery has traditionally relied on lifting restrictions, that may not be appropriate in the current pandemic. Serological testing and certification that may be necessary in the recovery process are better achieved at the national or regional level, in part because of the significant data management and privacy issues involved.

5. Is there a downside to regionalization?

A move from the present globalization wave towards a more regionally-based economy would bring some disadvantages. National and regional responses may not be as effective in countering some of the global problems that the world faces such as cybercrime, global warming and cross-border criminal activity. For many of these issues, the pace of resolution has been glacial and, in the case of global warming, disjointed. In other cases, such as the “War on Drugs”, different nations are now pursuing alternative solutions, recognizing that there is usually more than one (Global Commission on Drug Policy 2018).

Greater regionalization will likely also mean reduced investment in global disaster risk awareness and management. If global institutions such as the World Health Organization are weakened by budget cuts and policy disagreements, the world may be less well prepared for future disasters. Offsetting this concern, businesses are likely to invest more resources in environmental scanning and risk management. For example, as supply chains become more resilient, that resilience should be reflected in a commitment to broader stakeholder interests and accountability through supply chain mapping and the adoption of resilience-based key performance indicators such as responsiveness and reconfigurability.
Moving beyond the purely economic dimensions to the broader military and policy dimensions, concern is growing about the hardening of attitudes in both the United States and China, and against China globally (Silver et al. 2019). An undue focus on the nation State can also be dangerous for the world economy, as seen in numerous past conflicts triggered by extreme nationalist views. Regionalization could help minimize such risks.

A further cost of regionalization is the danger of fragmentation with the growing adoption of incompatible regionally-based standards and technologies. One risk is so-called “technology walls”, with irreconcilable technologies being adopted in different regions, particularly in China and the United States. This could emerge in telecommunications operating systems and 5G or 6G technology, in GPS navigation with the expansion of China’s BeiDou system, and in the Internet of Things (Walia 2020). Duplication would be costly, reducing scale economies and production interoperability. There is even speculation about the fragmentation of the internet (the “splinternet”) which could raise the costs of communication, control and data management.

A counter to this concern is the view that regionalization is neither likely nor feasible as globalization has tied firms to key locations that provide crucial hubs for production, finance, information and logistics. Replicating these hubs, which depend on thousands of interrelated contributors in a given region, would be a vast undertaking (Farrell and Newman 2020). In some cases, the degree of dependency, particularly on China, would be difficult to break. Dun and Bradstreet (2020) estimate that 51,000 MNEs have direct suppliers in Wuhan alone, while five million firms have one or more second-tier suppliers in Hubei Province. China is the world’s leading producer and exporter of active pharmaceutical ingredients, and both India and the United States are critically reliant on continued supplies (Miller and Cohrssen 2020).

Finally, some argue that globalization is already undergoing a transformation that will address some of its failings. The slowdown in the pace of globalization since 2015 has primarily affected capital and trade flows, the traditional engines of global growth. It is suggested that a change in the composition of globalization, particularly the growth of digital exchange (MGI 2016), could bring about a more equitable and inclusive global economy. The weakness of this claim is a failure to recognize the huge digital and information gaps that persist (Chinn and Fairlie 2007).

6. Conclusions

This paper suggests that the current globalization wave will transform into a stronger regional focus as a result of underlying weaknesses in globalization and in response to the disruption of the COVID-19 pandemic. The current disruption is
unlike previous shocks in its suddenness, global impact and uncertainties about recovery. It is also occurring at a time of contestable economic hegemony. The concurrence of these events has led to a reconsideration of global supply chains and recognition of their significant vulnerabilities. A move to a more regionally-based international economy offers the possibility of a better balance of national and international interests, helping counter growing populism, nationalism and protectionism. Although regionalization may lower global welfare through its reduced scale and higher costs, emerging technologies could be used to both increase resilience and maintain efficiency.

The implications for FDI are significant, likely reductions in interregional knowledge and FDI flows but a corresponding increase in intraregional flows. GVCs may be physically shorter, but fragmentation will continue as intraregional specialization develops. Relocation through reshoring and nearshoring will occur but existing centres – China, Germany and the United States – will remain regional drivers. Investments will become increasingly market-seeking rather than efficiency-seeking as regional specialization deepens. Vertical FDI will be complemented by growing horizontal investment as regions seek to broaden their skill bases. Increased competition for FDI means there will be a need for effective regional coordination, investment promotion and industrial policy to minimize wasteful duplication. Intraregional cooperation will become critical as specialization is pushed from the global to the regional level. Finally, the efficiency costs of increased regionalization must be offset against the opportunities to create a more inclusive, equitable and acceptable global regime.
References


