DE-GLOBALIZATION: WHERE DOES THIS LEAVE THE GLOBAL LOGISTICS INDUSTRY?

In a recent conference call hosted by Stifel Capital Markets, John Manners-Bell set out his views on de-globalisation and the trend towards regional and local supply chains, including implications for logistics service providers. The following paper is based on his presentation.

Introduction

We are all very aware of the major trends in the last half century which have brought about the creation of first regional supply chains and subsequently global ones. This has been a result of a process which is referred to as an 'unbundling' of manufacturing in order to exploit the comparative advantage which some countries have developed in certain sectors and processes. In some cases this relates to the level of value add which they can contribute, in others to lower costs, especially those related to labour.

Although the picture is somewhat confused by a range of trends and counter trends, I believe that what we will see in the next 20 years will be a movement towards de-globalisation, firstly through the regionalisation of downstream distribution and then to location-specific supply chains. Some of the evidence for this is already in place.

Trade and globalisation

The global logistics industry is already seeing a major change to the relationship which drove its development for the last three decades and before. On average, between 1990 and 2008, real GDP grew at 3.2% a year, whilst world trade grew at twice this rate. This relationship was considered to be 'hard-wired', that is until the financial crisis of 2009. The 2:1 ratio has since been replaced with a direct 1:1 correlation, meaning that most trade forecasts were firstly affected by the downturn and secondly by a structural change in market growth.

Why is this? Well there are several reasons. The first is that developed countries – including the Eurozone - have yet to fully recover and therefore there is less demand for imports of consumer goods.

Second, developing countries have been forced to focus their investment on domestic infrastructure to maintain their rate of economic growth. Of course China is the best example of this.

Third, as I will discuss in more detail below, the downturn has created more protectionist policies which have acted as a drag on international trade.

And fourth, governments around the world have actively suppressed short term consumer demand in their own economies.

Protectionism – a drag on trade and economic development

Let me briefly talk about protectionism. Since the financial crisis, governments around the world have quietly enacted 1527 'beggar-thy-neighbour' measures to protect their domestic markets. This is according to the organisation Global Trade Alert. Of these 89% remain in place today, despite a so-called 'standstill' on such legislation.

Amongst these you can include Russia's e-commerce regulations which led to DHL, UPS and FedEx suspending international services into the country for a week. Likewise Argentina has made it very difficult for its citizens to buy international goods over the internet in order to prevent flights of currency.

It is not all bad news though. The WTO's Bali agreement was, you might say, the success of perseverance over expectation. One estimate suggests that the trade-facilitation measures agreed in Bali could cut the cost of shipping goods by more than 10%, raising global output by over $400bn a year. Poorer countries will be the main beneficiaries. Other positive initiatives include the Transatlantic Trade and Investment Partnership, the Trans-Pacific Partnership and ASEAN.

Suppressing consumer demand and international trade

It may seem counter-intuitive that governments should try to dampen economic growth at this time, but perhaps inadvertently, this is exactly what has happened. They have done this through a combination of encouraging consumers to pay down debt, increase savings level (for example through tax breaks) and most importantly by restricting pay awards.

In Germany this occurred in the early 1990s as its government worried at the loss of competitive advantage to manufacturers in Asia due to low labour costs. Hence pay scales were re-structured, which although you could argue was in the long term benefit of its economy, had the effect of actively reducing the amount spent on imports. More recently in the UK and elsewhere, the austerity measures and pay freezes in the public sector initiated by governments have had the same impact.

Looking at Emerging markets we can see the same effect, albeit for different reasons. It has been said that China and India have yet to really join the consumer revolution, and one of the major reasons for this is the Savings Rate in these countries. By Savings Rate I mean household savings as a proportion of GDP. In China this rate is 50%, compared to a global average of 20%. This level is due to the level of precautionary savings by Chinese families as people put away money for their old age, housing, education and healthcare. Jitters in the Chinese economy have encouraged the rate to rise rather than decrease.

As more of a social 'safety net' is put in place, and governments develop health plans and state pensions, this may change. China's rate of 50% after all compares with that in the US and UK of 11% in 2009. However we shouldn't expect a boom – there is huge income inequality in China where 80% of savers have only very small savings. For consumer markets to work well, income should be spread much more evenly although lifting populations out of poverty (as globalisation indisputably has) is a first step.

From globalisation to regionalisation

It is my belief that we are already moving from the era of globalisation to that of regionalisation of supply chains. This involves a transformation from East-West and West-East Flows to complex networks of developed and emerging markets in Asia, Latin America and Middle East/Africa. What is the evidence for this?

Firstly, global flows of goods are becoming more disparate. In 1990 63% of global flows of goods moved through the top 50 routes. By 2011 this had fallen to 54%.

Secondly, Cross-border flows of goods, services and finance from emerging markets in 2012 accounted for 38% of the total, up from 14% in 1990.

And thirdly, south-south trade has grown from 6% of goods flows in 1990 to 24% in 2012.

This shows that trade is re-balancing – with obvious consequences to shipping lines, air cargo carriers and freight forwarders.

An example of this involves European automotive manufacturer, Volkswagen. In the past it had adopted a very much ‘Germany to the world’ model, where all production was undertaken in Europe, and product exported to the rest of the world. This strategy has undergone a transformation. It now manufactures in Germany, Asia, Africa and North and South America and it has also established a number of regional hubs through which components are routed. The result is a complex network of flows, some of which are global; many South-South; some intra-Americas; some intra-African and of course a large proportion intra-Asian.

Whilst the last example was from the auto sector, the ‘Factory Asia’ model is best known in the high tech industry. It can be best measured by trade in ‘intermediate goods’ – the components which go in to making a final product. In Asia, the assembly of intermediate goods usually occurs in China with the value add taking place in other Asian countries where they have been able to develop a comparative advantage. For example the manufacture of hard disk drives in Thailand.

Asia has been able to develop effectively as a regional hub for the manufacture of intermediate goods creating enormous trade flows. In 1995 Asia accounted for just 26% of world exports in intermediates compared with Europe’s share of 50%. By 2009 this had grown to 35% whilst European trade had dropped by 9pp to 41%. Intra-regional trade now makes up almost two thirds of all trade in intermediate goods in Asia and 71% of trade in Europe.

In other words, the majority of component parts being produced by manufacturers in Asia stay in Asia and the same can be said for Europe. In terms of trade of intermediate goods, these regions are by some distance the largest two markets and dwarf global flows of product.

Next step –regionalisation of downstream distribution

Up to this point I have been describing the market as it has developed, with regional flows of goods becoming more prominent. Arguably the biggest changes are yet to come. The upstream supply chain has already regionalised, as we have seen, and the next step is the regionalisation of downstream distribution channels.

By this I mean the development of consumer markets in Asia, Africa and Latin America. Not only will intermediate goods manufactured in Asia stay in the region – and this is the point – so will finished product.

This will occur due to the development of a more affluent society. By 2020, it has been estimated that 1.8 billion people in emerging markets will enter a 'consuming class,' spending $30 trillion, up from $12 trillion today. Emerging markets constituted just below half of world GDP in 2012 up from about one third in 2000. In the next decade this shift will continue (albeit at a much slower speed). For the next year, GDP growth in emerging and developing economies as a whole is projected to improve slightly by 0.3pp to 4.8%.

The consumer packaged goods sector is a very good example of these changes. Emerging markets are very important to these manufacturers because their goods are quite low value and within reach of populations which are just starting to increase their living standards. High demand for every day, high volume, low price point products will be driven by the migration of the 'have nots' to 'haves.'

Multinational manufacturer Unilever is already well-positioned in emerging markets and forecasts that in a few years' time around two thirds of its sales will be generated in these regions. What is important is that Unilever's production strategy involves local production for local markets, a key point that I will return to later.

…And then localisation

Following the regionalisation of upstream and subsequently downstream supply chains, my argument is that supply chains will then become more localised in character. Why is this?

Firstly there is the trend towards near-sourcing and re-shoring, which has received a lot of coverage recently in the media. The unbundling and out-sourcing manufacturing strategy which has led many companies to embrace the usage of remote suppliers is starting to unravel. In an MIT survey, 34% of respondents stated that they are "considering" bringing manufacturing back to the U.S., while 15% of U.S. companies responded that they are "definitively" planning to re-shore to the U.S.

The most important reason for this relates to ‘time to market’ as well as ‘cost reductions’, ‘product quality’ and ‘hidden supply chain costs’ – which could include supply risk factors such as natural disasters and security concerns.

As the researchers themselves say, ‘We are in the middle of a transformation from a global manufacturing strategy, where the focus is on low cost countries, to [one] where China is for China, U.S. (or Mexico and Latin America) is for the Americas and Eastern Europe is for European markets.’

What’s driving re-shoring?

There are a number of reasons behind the trend towards ‘re-shoring.’ Firstly manufacturers, especially in the US, are experiencing lower energy costs due to the fracking phenomenon. This obviously makes manufacturing in the US more competitive and rebalances the out-sourcing equation. Lower energy costs also make international logistics costs cheaper, but they will still be more expensive than domestic freight rates.

Secondly, labour costs in Asia are rising. Specifically in China wages have been growing by 10-20% annually for many years, compared with low single digits in the US and the developed world. Again this is readdressing the cost differential.

Thirdly the increased use of automation and robotics in developed countries has led to increased productivity and offset the advantage of cheap labour. There is now more focus on a skilled work force and value adding processes.

Fourthly, manufacturers are increasingly costing-in supply chain risk such as natural disasters, security, delays, quality control etc. Many companies took a hit in the wake of the Japanese tsunami disaster or the floods in Thailand and this has changed the way they look upon risks in their supply chains.

Local production for local people

For Unilever and other global brands, sales growth in emerging markets will not necessarily result in higher global flows of goods. That is because successful penetration of emerging markets relies on developing products for specific, local markets and delivering these quickly, cheaply and efficiently.

To this end Unilever, followed by its peers, has invested heavily in local and regional facilities. For example it has invested $500m in production and distribution facilities in Mexico as well as $75m in a factory in Colombia.

The issue of transport provision is important in this respect. Although these companies would like to work with global logistics providers, in many cases this just isn't possible. Meeting these needs will be absolutely key for the future of the logistics industry.

Another factor in the 'localisation' of supply chains in emerging markets, will be the development of 'mega-cities' – usually defined as a city of over 10 million people. The top ten fastest growing mega-cities in the world are all in emerging markets – four in China and three on the Indian sub-continent.

At a more micro level, Bain estimates that the number of cities in emerging markets with populations of more than 50,000 will be four times the number in the developed world by 2030. This demonstrates the extent to which urbanisation is occurring.

Another illustration is that, in 2005, retailers and consumer goods manufacturers had to develop distribution channels in 60 cities in China to reach 80% of the country's population. In 2020, these companies will need to be present in 212 cities to reach the same market. Consequently, logistics will increasingly be focused around cities rather than countries.

Why should this have an impact on supply chains? Well, mega-cities will create their own economies of scale, supplied by local/regional production facilities. Consumer goods will be customized to local tastes and each city will develop its own unique eco-system, which takes into account the movement of people, data, finance, energy, waste, goods and services. Transport demands will be specific to each city's needs and capabilities: poor planning and infrastructure would result in high logistics costs. Fulfilment, packaging, miniaturization and reverse logistics will require increased intensity of logistics provision.

Although there may be some homogeneity in logistics and supply chain terms across regions, it will be very dangerous for businesses to take this for granted. There will be far more customisation and specialisation in terms of product and service delivery than many might hope.

The supply chain of the future

So far we have seen how supply chains are moving from globalisation to regionalisation, and onwards to more localised provision of products and services. I believe that 3D printing will act as an accelerator of this trend on both an upstream and downstream supply chain basis.

Upstream, 3D Printing, or additive manufacturing as it is called, has the potential to reduce the volume of intermediate goods – and consequently unravel the concept of 'Factory Asia'. Instead of components being produced in another location or country, there would be a re-bundling of Tier 1+ activities. China is major investor in 3D Printing and so definitely understands the power of the concept. This would allow China to re-capture value add which is presently 'lost' to manufacturers in other Asian countries.

From a logistics perspective, the impact of this is that fewer transport and logistics services will be required as more goods are manufactured in a single factory prior to final distribution. Given that 3D printing is already being adopted widely by many industry sectors, this scenario really isn't too far off.

The impact of 3D Printing on downstream supply chains is less imminent. 'Consumerization' of manufacturing, however, is definitely a possibility, in which case global and regional supply chains could be rendered redundant (in some sectors at least).

Consumers may end up being able to print some objects in their home, or at least visit a local facility and have them printed there. This would eliminate the need for the movement of many types of products, although of course the types would be limited.

However I believe spare parts will be the first sector to be impacted – service engineers, for example will be able to 'print' parts at a depot or on site. Global parts centres and regional stocking of slow moving components would become obsolete which would of course have enormous implications for many express companies active in the market.

Summary

In the short term, I foresee that upstream regionalization of supply chains will continue – the 'Factory Asia' business model will be with us for some time. However the downstream regionalization of supply chains and distribution will start to occur as the Middle Class in emerging markets starts to develop. We will increasingly see a manufacturing industry characterised by 'Asia for Asia', for example.

The re-shoring/near-sourcing trend will also develop and this will lead to higher levels of regional volumes flows within developed markets such as North America and Europe, helped by automation, robotics and lower energy costs.

In the medium term we will see supply chains become more localised. In China, there will be increased value added production through 3D Printing and as a result less movement of intermediate goods. The rapid expansion of mega-cities in Asia, Latin America and Africa will create demand for urban logistics services moving locally produced goods.

3D Printing will eventually impact on the distribution of downstream goods as consumers are able to create products in their homes. This will produce new flows of goods, perhaps of the substrates needed to supply the 3D Printers themselves.

Conclusion

There is no doubt that growth in global trade will be with us for many years to come. Many of the trends which I have outlined will be value enhancing in economic terms and therefore stimulate economic growth and wealth creation. Naturally this will create a demand for goods wherever they are produced. Some commodities – energy resources such as minerals or oil, for instance – are specific to certain locations and will always need to be transported around the world.

The point of this paper is not to so much to herald the death of globalisation; rather it is to demonstrate that major changes in the dynamics of the world's economy, supply chains and logistics are already underway. In the next twenty years the industry will experience systemic change, and all players will need to be agile enough to respond.

For example, if this scenario of localised supply chains materialises, global logistics companies will have to learn to compete effectively in emerging markets on a domestic, even city-by-city basis. So far we have seen many of the big names fail in this respect. However in the long term it is not viable for them to focus on global flows of goods when the reverse of this trend is already starting to occur.

If you find the issues discussed in this whitepaper relevant to your business then you may be interested in attending Ti's upcoming Emerging Markets Logistics conference on June 4th-5th, Dubai. John Manners-Bell as well as other senior Ti analysts and industry figures will present and discuss future challenges and opportunities for supply chain and logistics. Contact Sarah Smith, Ti's Head of Events for further details E: ssmith@transportintelligence.com

John Manners-Bell is CEO of Transport Intelligence, a global provider of market research to the logistics and supply chain industry. He is also Chair of the Logistics and Supply Chain Global Agenda Council of the World Economic Forum. He has authored two books on the industry: Global Logistics Strategies: Delivering the Goods and Supply Chain Risk: Understanding Emerging Threats to Global Supply Chains. His next book, Logistics and Supply Chains in Emerging Markets is published later in the year.